

Principle of maximum social advantage

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Introduction

- ▶ Fiscal operations of government involves transfer of purchasing power from one section of society to another section of society. Fiscal activities of government affects the allocation of resources and thus output and employment within economy. it is imperative to evaluate benefits or losses emerging from such activities and determine optimum level of governments budgetary actions.

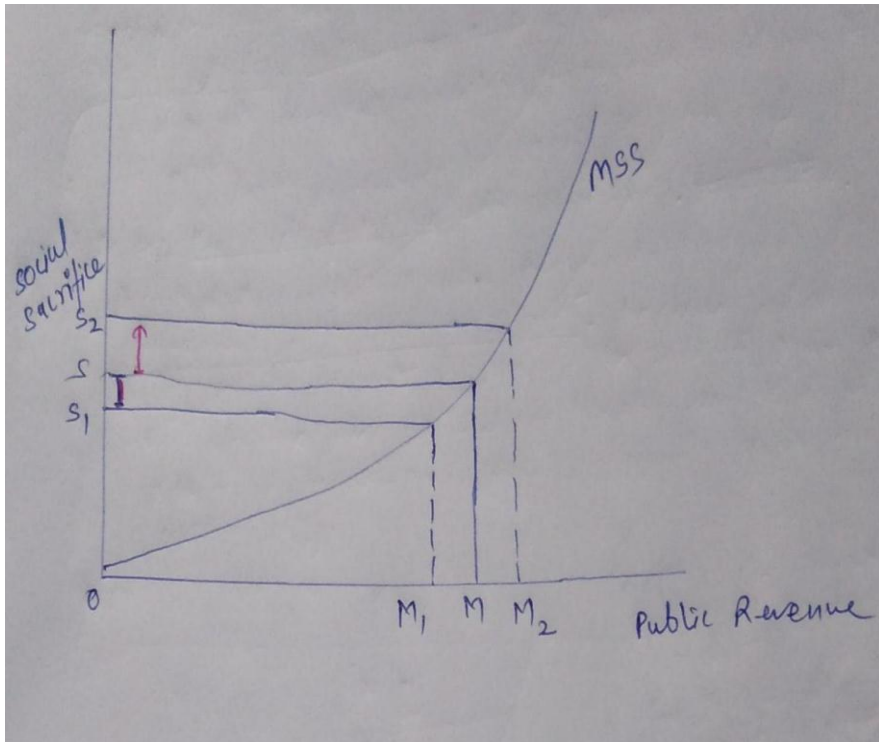
Principle of MSA

- ▶ Public expenditure are subject to diminishing marginal social benefit and taxes are subject to to increasing marginal social sacrifice the social advantage is maximum when aggregate social benefit resulting from public expenditure and aggregate social sacrifice in raising the public revenue is minimum.

MSS

- ▶ Every unit of tax imposed by the government result in loss of utility because it reduces the purchasing power of the community additional burden from additional units of taxation increases at an increasing rate because additional unit of taxation puts greater amount of sacrifice on society than previous units of of same amount of taxation does the additional burden on additional units of taxation goes on increasing.

MSS curve



- ▶ MSS curve is an upward rising curve from left to right.
- ▶ For the same amount of increase in taxation M_1M and MM_2 to the MSS on additional tax MM_2 is SS_2 which is higher than the MSS of SS_1 on previous tax M_1M of same amount.

MSB

- ▶ Every unit of public expenditure provides utility to the community. The units of public expenditure are at first spent on most essential social goods and subsequently are spent on less and less important social goods so marginal social benefit from each additional unit of public expenditure goes on decreasing.

MSB curve

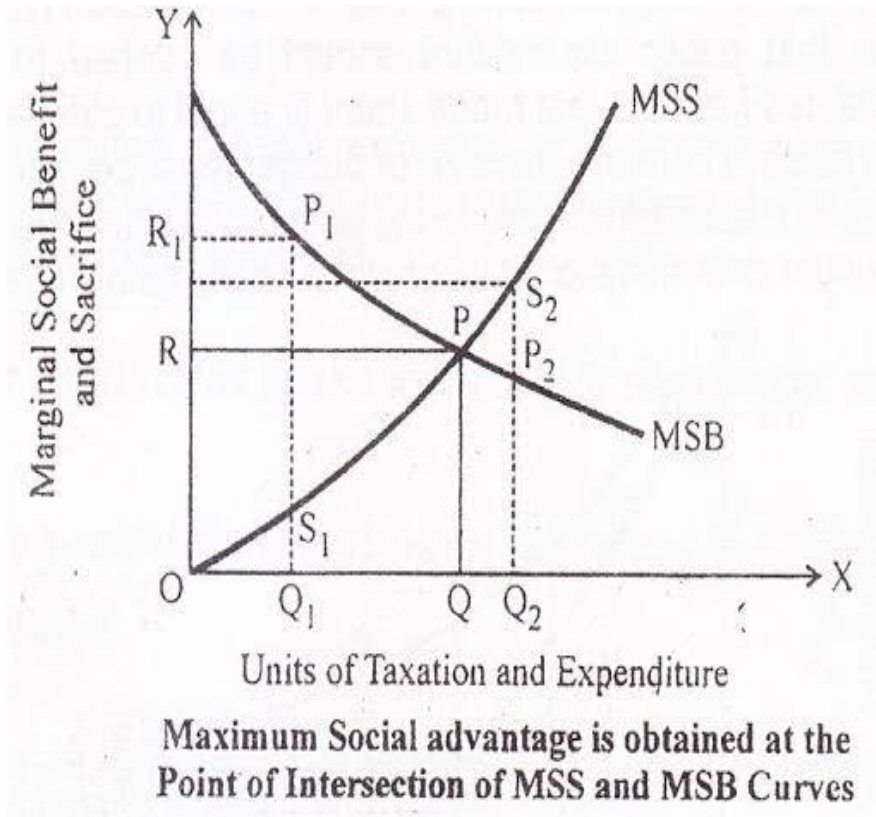


- ▶ MSB is a downward-sloping curve from left to right.
- ▶ For the same amount Public expenditure M_1M and MM_2 the decline in MSB for additional unit of public expenditure of MM_2 is more than the decline in MSB for previous unit of public expenditure M_1M .
- ▶ Decline $SS_2 > SS_1$

Assumptions of MSA

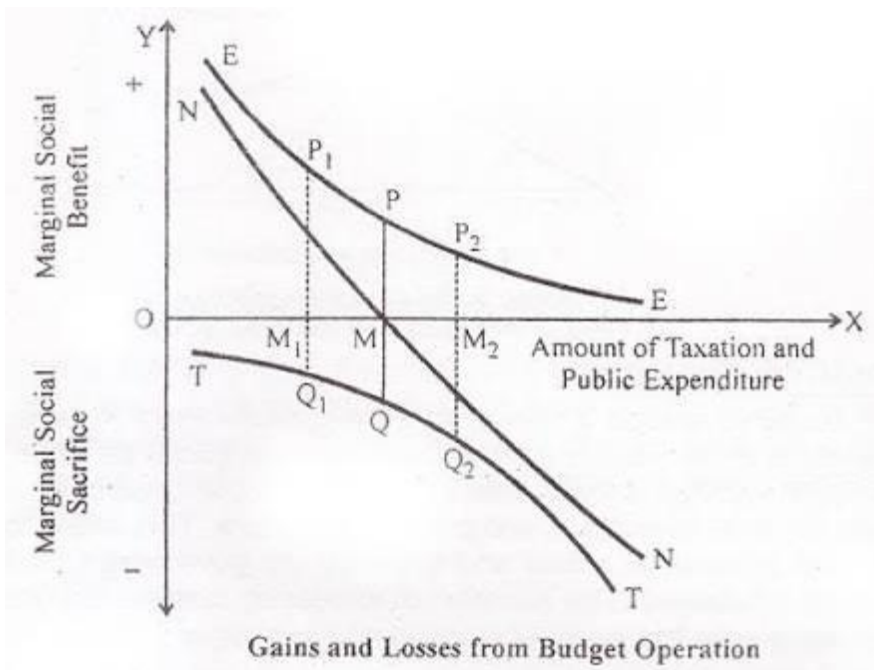
- ▶ Taxes are the only source of public revenue
- ▶ Government has balanced budget
- ▶ The public expenditure is subject to diminishing MSB (marginal social benefit)
- ▶ The public revenue is subject to increasing MSS (marginal social sacrifice)

State of MSA



- ▶ The maximum social advantage is achieved at the point of equality of MSS and MSB.
- ▶ The optimum level of taxation and expenditure is OQ at which $MSS=MSB$
- ▶ The Aggregate social advantage is the area OPY

Musgrave's version of MSA

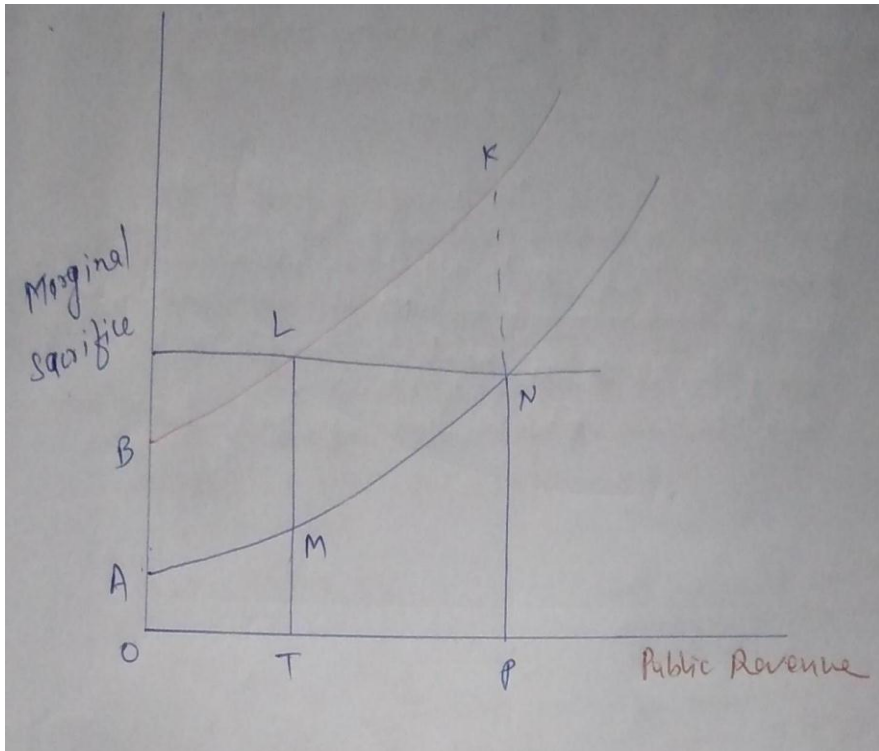


- ▶ The line NN represents the difference between the MSS and MSB
- ▶ The point of MSA is OM at which line NN intersects X axis. Beyond this point the $MSS > MSB$.

Two sector model of MSA

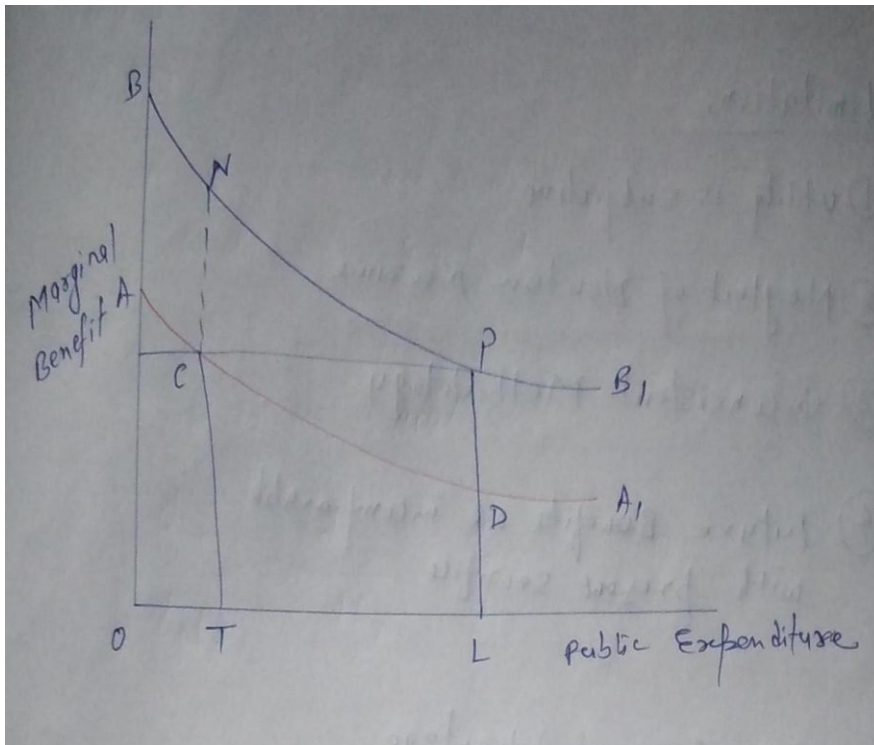
- ▶ If two or more sources of public revenue is available as private sector and public sector then taxation should be imposed on the basis of equimarginal sacrifice between the two or more sources of revenue
- ▶ The level of public expenditure is determined on the basis of equimarginal benefit from each item of expenditure public and private sector

MSS in two sector model



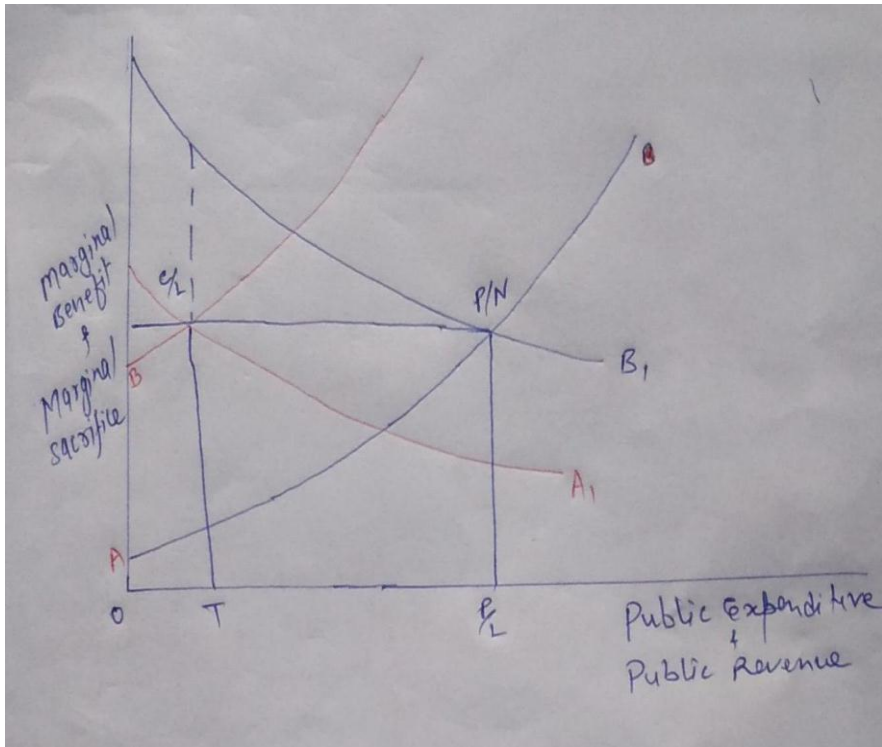
- ▶ The MSS from taxation on both sectors is equal $LP=PN$. At which taxation in public sector is OT and taxation in private sector is OP .
- ▶ If instead OP Tax is collected from Public sector and OT Tax from private sector it results in net increase of $KLMN$.

MSB in two sector model



- ▶ The MSB from private sector and public sector is $CT=PL$. At which expenditure in public sector is OT And OL in private sector.
- ▶ If OL amount is spent on private sector and OT amount is spent on public sector it results in a net decrease in MSB equal to area $NCDP$

MSA in two sector model



- ▶ The best level of public expenditure is OL In private sector and OT In public sector
- ▶ The best level of taxation is OL In private sector And OT In public sector
- ▶ At this level the MSS and MSB are equal across sectors as well as within sectors

Two propositions of MSA

$$\textcircled{1} \text{MSB} = \text{MSS}$$

$$\frac{db}{de} = \frac{ds}{dt}$$

$\textcircled{2}$ (a) MSB for an additional unit of expenditure should be equal for ~~every~~ across all items of expenditure

$$\frac{db_1}{de_1} = \frac{db_2}{de_2} = \dots = \frac{db_n}{de_n}$$

(b) MSS from each additional unit of revenue must be equal across all tax sources

$$\frac{ds_1}{dt_1} = \frac{ds_2}{dt_2} = \dots = \frac{ds_n}{dt_n}$$

Tests of Social Advantage

Dalton's tests

- ▶ Preservation of community
- ▶ Improvement in production
- ▶ Improvement in distribution
- ▶ Stability and full employment
- ▶ Provisions for future

Hick's tests

- ▶ Production optimum
- ▶ Utility optimum

Limitations of MSA

- ▶ Utility is subjective cannot be measured accurately
- ▶ Neglect of nontax revenue
- ▶ Inconsistent methodology
- ▶ Future benefits are incomparable with present sacrifice
- ▶ An imbalanced budget is often an effective way to tackle market failures and thereby enhancing aggregate social advantage
- ▶ Productivity efficiency of public expenditure is not directly related to size of public expenditure but several other factors