02: Principle of Maximum Social Advantage

Introduction:

The 'Principle of Maximum Social Advantage' was introduced by British economist Hugh Dalton.
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.
This results in changes in pattern of production, consumption & distribution of income and wealth. So it is important to know whether those changes are socially advantageous or not.
If they are socially advantageous, then the financial operations are justified otherwise not.
According to Hugh Dalton, "*The best system of public finance is that which secures the maximum social advantage from the operations which it conducts.*"

Principle of Maximum Social Advantage (MSA) :

The 'Principle of Maximum Social Advantage (MSA)' is the fundamental principle of Public Finance.

The principle of maximum social advantage implies that public expenditure is subject to diminishing marginal social benefits and taxes are subject to increasing marginal social costs. Thus, an equilibrium is reached when social advantage is maximised, i.e., when the size of the budget is such that marginal social benefits of public expenditures are equal to the marginal social sacrifice of taxation.
Dalton states, “Public expenditure in every direction should be carried just so far, that the advantages to the community of a further small increase in any

direction is just counter-balanced by the disadvantage of a corresponding small increase in taxation or in receipts from any other sources of public expenditure and public income."

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 MU (Marginal Utility) of expenditure is equal to (=) the Marginal Disutility or the sacrifice imposed by taxation.

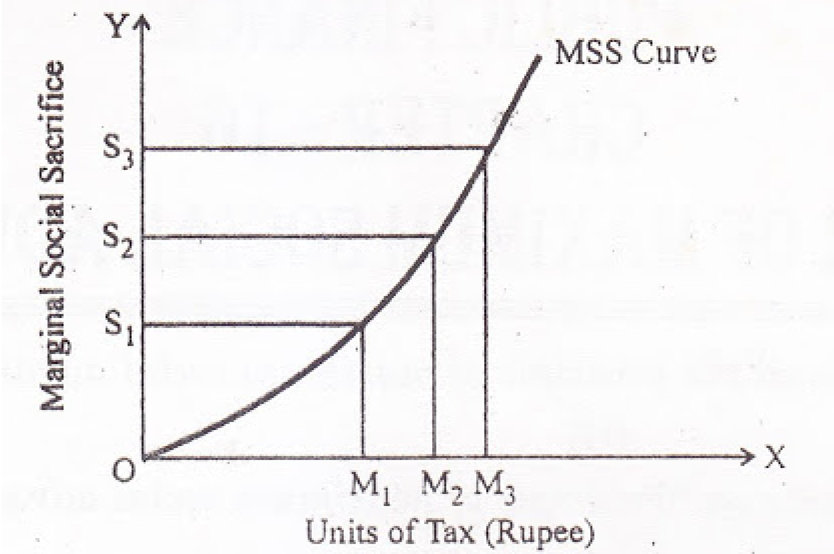
Hugh Dalton explains the principle of maximum social advantage with reference to :-
Marginal Social Sacrifice
Marginal Social Benefits

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

Marginal Social Sacrifice (MSS) :

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. As a result of diminishing stock of money, the marginal utility of money goes on increasing. Eventually 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 :-

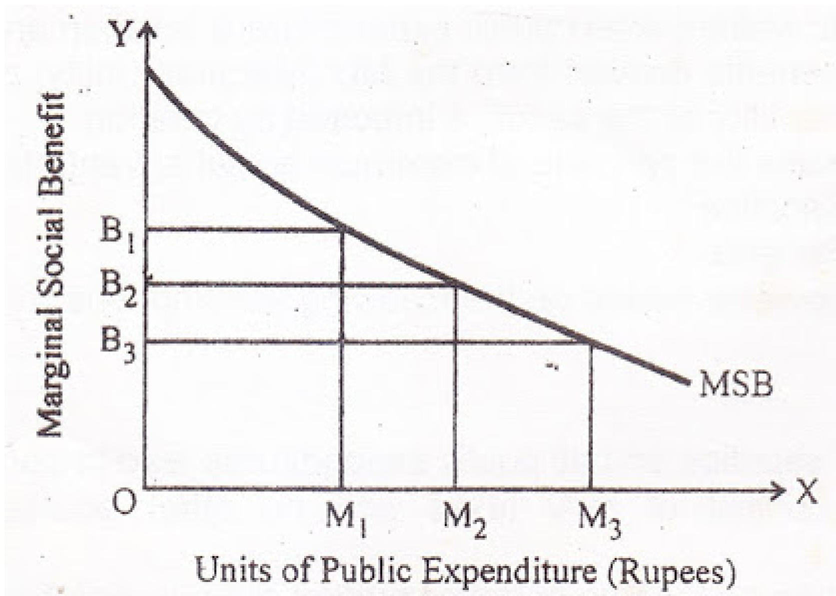


Increasing Marginal Social Sacrifice Curve

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 increases. When the unit of taxation was OM_1, the marginal social sacrifice was OS_1, and with the increase in taxation at OM_2, the marginal social sacrifice rises to OS_2.

<u>Marginal Social Benefit (MSB) :</u>

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.

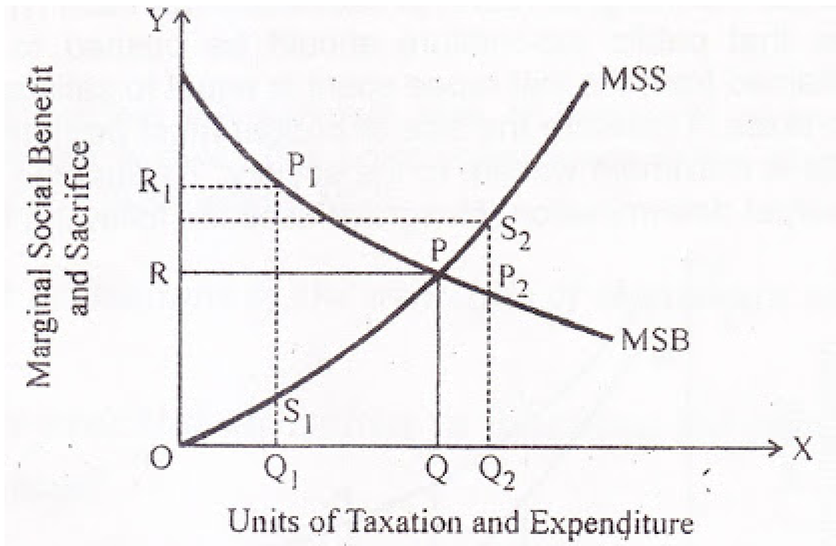


Diminishing Marginal Social Benefit Curve

In the above diagram, the marginal social benefit (MSB) curve slopes downward from left to right. This indicates 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.

<u>The Point of Maximum Social Advantage :</u>

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



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

At point P 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 spent 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.

Conclusion:

Maximum Social Advantage is achieved at the point where the marginal social benefit of public expenditure and the marginal social sacrifice of taxation are equated, i.e. where MSB = MSS.

This shows that to obtain maximum social advantage, the public expenditure should be carried up to the point where the marginal social benefit of the last rupee spent becomes equal to the marginal social sacrifice of the last unit of rupee taxed.

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