
UNIT 13 THEORY OF PUBLIC EXPENDITURE

Structure

- 13.0 Objectives
- 13.1 Introduction
- 13.2 Classification of Public Expenditure
- 13.3 Size of Public Expenditure: Theoretical Stance
 - 13.3.1 Maximum Social Advantage
 - 13.3.2 Budget Maximisation
 - 13.3.3 Revenue Maximisation
- 13.4 Theory of Public Expenditure
 - 13.4.1 Wagner's Law (Law of Increasing Public Expenditure)
 - 13.4.2 Peacock-Wiseman's Hypothesis (Displacement Effect)
- 13.5 Efficiency-Equity Trade-off
- 13.6 Let Us Sum Up
- 13.7 Key Words
- 13.8 Some Useful Books
- 13.9 Answers or Hints to Check Your Progress Exercises

13.0 OBJECTIVES

After reading this unit, you will be able to:

- classify public expenditure categories in terms of their functional and economic bases;
- outline Dalton's principle of 'maximum social advantage' as the criteria of public expenditure;
- explain how the size of public expenditure is determined under the Niskanen's 'budget maximisation' approach;
- highlight the argument behind the 'revenue maximisation' approach to public expenditure;
- describe the thrust behind Wagner's law of increasing public expenditure;
- discuss the displacement effect in the Peacock-Wiseman's hypothesis of public expenditure; and
- write a note on the issues behind the 'efficiency-equity trade-off' in public expenditure.

13.1 INTRODUCTION

Public expenditure, or government spending, is incurred on provision of public goods, dispensation of public services, construction of public works, transferring resources for social security, subsidisation of merit services and in running public utilities. Giving grants/loans to other governments (or to parastatals) may also be considered public expenditure. It is sometimes classified in terms of public consumption and public investment and transfer payment, and at others, as final expenditure outlay. With evolution of democracy over past couple of centuries, quite a few other activities, besides those related with police state, have been entrusted to (or assumed by) the State. With this, the State has come to acquire adjectives like 'welfare' and 'development'. Due to technological advancements, many public goods have emerged which merits mass consumption. As per Musgrave, the government reallocates and redistributes resources of the society and also works for stabilisation of the economy through fiscal instruments (including expenditure).

Revenue collected by governments is used as public expenditure for establishing public services at different levels of government (centre, intermediate, local). While totalling expenditures of two levels of governments, where grants are given by a higher level of government to lower level governments, care should be taken to avoid double counting (grants being financial disbursement to be effected as real expenditure at the lower level). Likewise, expenditures like interest payment on debt incurred by a government, need to be duly taken account in the classification system adopted.

13.2 CLASSIFICATION OF PUBLIC EXPENDITURE

Public Expenditure or government spending means expenditure incurred by a government. The term 'public finance' is confined only to government expenditure. A broad classification, as practiced in India, is presented here. There are two broad classification of a government's (of any level) budget viz. economic classification and functional classification. Under economic classification, both receipts and expenditures are divided into current (revenue) and capital accounts. Note that the 'revenue' is considered equivalent to 'current'. It is a two-way and two-fold classification i.e. (i) revenue receipts and revenue expenditure and (ii) capital receipts and capital expenditure. Capital account deals with assets and liabilities while current account deals with current revenue and current expenditure. Total expenditure is divided into: (a) current expenditure and (b) capital expenditure. The 'current expenditure' is further divided into: (i) compensation of employees, (ii) purchase of goods and services, (iii) interest payment on debt, (iv) subsidies, (v) grants, (vi) social benefits, etc. Likewise, 'capital expenditure' is divided into: (i) purchase of assets, (ii) building of assets, (iii) financial investment, (iv) loans, etc. The classification of 'capital expenditure' is also called as economic classification. The functional classification is made in terms of: (i) general public services, (ii) services related to economic affairs, (iii) social services and (iv) miscellaneous. Each of these is further broken into many sub-categories. This is presented by sectors of expenditure like defence, civil administration, education, health, culture, housing, environment, interest payment, etc.

An alternative classification of public expenditure is made as: (i) development expenditure and (ii) non-development expenditure. Non-development expenditure is incurred on items of general services like legislatures, judiciary, police,

diplomatic relations, currency operations, interest payment, etc. Development expenditure is incurred on sectors or activities like: (i) agriculture, irrigation, livestock and forestry development; (ii) industry, mineral and power development; (iii) transportation (road, railways, air and waterways); (iv) nuclear and space programmes, communication and telecommunications, education, health and nutrition, social security, etc. Development expenditure, therefore, covers both economic and social services.

13.3 SIZE OF PUBLIC EXPENDITURE: THEORETICAL STANCE

An American economist Richard W Rahn, a supply side supporter, set the goal of maximising growth and held that beyond a certain level (e.g. 25 percent of GDP), public expenditure would be counterproductive as it would compromise the level of growth (Fig. 13.1).

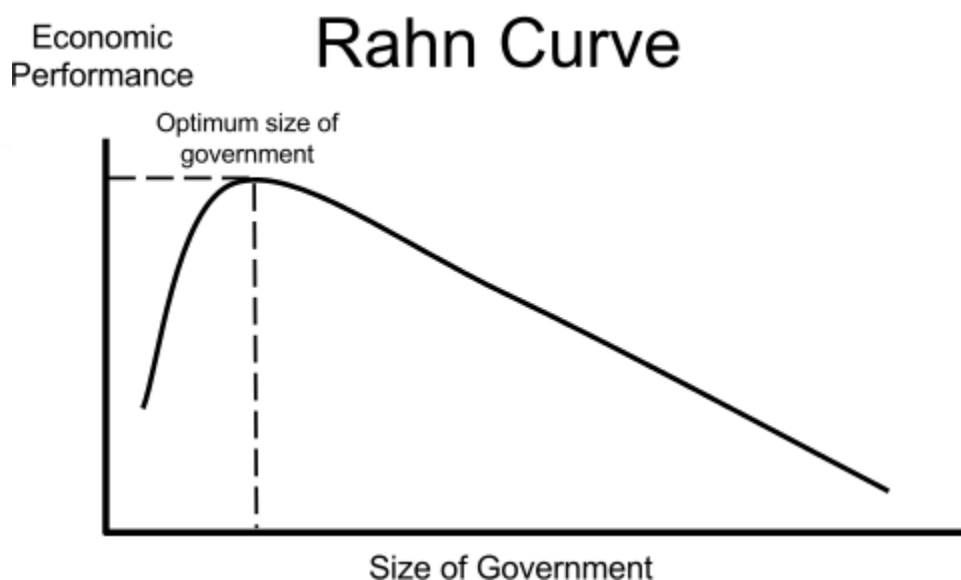


Fig. 13.1: Rahn Curve

13.3.1 Maximum Social Advantage

The principle of maximum social advantage was proposed in 1920s by H Dalton. It suggests that the limit of government expenditure should be set so as to derive 'maximum social advantage'. Holding that entire expenditure is met by taxation, the limit of taxation should coincide with that of public expenditure. As public expenditure goes on increasing, its marginal social advantage or benefit (MSB), in the manner of demand curve, keeps on decreasing; and as taxation goes on increasing, its marginal social sacrifice (MSS), like supply curve, keeps on increasing. Net social benefit (NSB), the difference between the two, keeps on decreasing from high positive to high negative passing through the zero point. When $NSB = 0$, $MSB = MSS$. Social benefit or social advantage, as Dalton called it, is maximum when the size of public expenditure is at a level where $MSB = MSS$. Therefore, taxation and expenditure should be carried up to this level and no further. Pigou, who was of the view that taxes are collected and proceeds spent in the interest of the governed, called it 'maximum aggregate welfare'. Richard Musgrave endorsed the principle but drew the diagram slightly differently. While Dalton drew it in the first quadrant (as the supply and demand curves are normally

drawn), Musgrave choose to use the first quadrant for MSB and the fourth quadrant for MSS (conceived as negative utility from taxation). Again, the difference between the two, shown as a curve, is first positive, then zero, and then negative. The resulting maximisation conditions would be the same.

Theoretically, it is necessary that taxation is so carried out that marginal sacrifice of each citizen is the same and expenditure is so carried out that marginal benefit from each line of expenditure is the same. This means, the principle of Maximum Social Advantage should be governed by two basic economic laws: (i) decreasing marginal utility and (ii) equi-marginal utility (with certain modifications). The chief criticism of the principle is the measurability of psychic quantities besides inter-personal comparison.

13.3.2 Budget Maximisation

The other strand is about how the size of public expenditure is actually determined. Public choice theory does not accept the government as a benevolent despot. People are as rational in political processes as they are in the market. Their actions in both the arenas, economic and political, are motivated by self-interest. In the budget maximising processes, there are three varieties of actors: voters, legislators and executives who are basically bureaucrats. William Arthur Niskanen, an American economist, with experience in US administration, proposed (in 1971) the 'budget maximising model' of bureaucracy, by adopting the public choice approach. According to Niskanen, rational bureaucrats will always and everywhere seek to increase the budget of the department they are in, in order to increase their power. Thus, they will contribute to the growth of State at the cost of society. It is very similar to Parkinson's law (popular in Public Administration), which says that 'work expands to fill the time available for its completion' much the same way as 'gas expands to fit the volume'.

A department comes into existence because there is demand for its services by the voters or electors. It offers the services to the voters-electors through the legislature in a democracy. The legislature defines the budget of a department depending on the quantity it supplies. The more the services, the higher the budget. The model assumes that the department's (bureau) policies and programmes are set by bureaucrats by taking into account the costs and benefits associated within a given range of output. It also assumes that bureaucrats attempt to maximise their personal utilities by satisfying 'self-regarding preferences' and that top bureaucrat decides the agenda to sell to the legislature. In a parliamentary democracy, political executives partly share the 'self-regarding' characteristic.

Usually, there are two kinds of departments: one earning revenue and the other spending revenue. The model proposes that the top bureaucrat in a spending department will try to maximise the department's expenditure budget and thus ensuring better pay packet and prestige. The department will propose to the legislature the services it will dispense to the public (which approves and authorises it to carry out the agenda). In Economics, maximisation is constrained maximisation. This maximisation, according to Niskanen, is subject to social welfare break-even constraint. There is social benefit from the services (schemes) and there are associated social costs (sacrifice) of dispensation. Instead of equating Marginal Social Benefit (MSB) with Marginal Social Cost (MSC), the department equates Average Social Benefit (ASB) with Average Social Cost (ASC). Thus, bureaucracy tries to push the production/provision of services up to the level where citizens' (consumer's) surplus is 'nil'. Thus, the deadweight loss will be equivalent to total surplus it could generate by equating MSC with MSB

(Fig. 13.2). It can be seen that instead of attempting to produce at Q_0 level it prefers to go to Q_1 level. This oversupply generates allocative inefficiency.

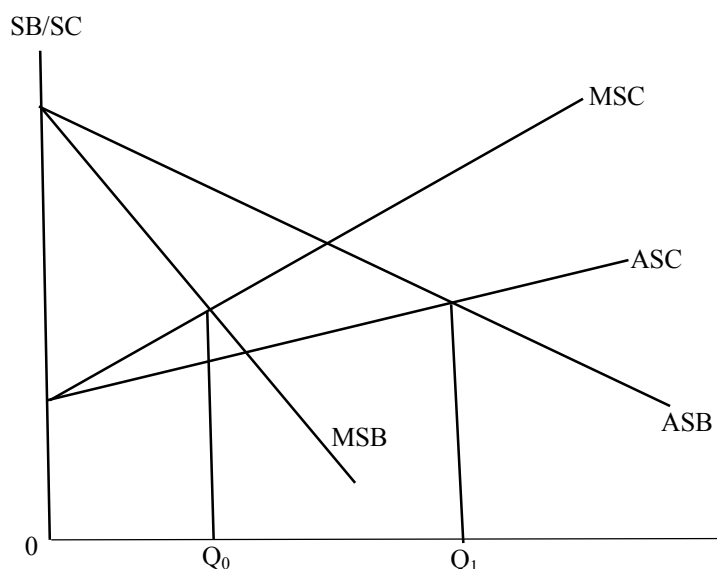


Fig. 13.2: Determination of Size of Service

Niskanen adds that it also generates x-inefficiency by producing services inefficiently in the sense that the actual cost curve will be higher than warranted by technical considerations. Thus, the actual ASC and MSC curves would be higher than they ought to be.

Why does the service not go beyond Q_1 level? It is quite likely that the excess is discovered by the legislators and the quantum of services is drastically reduced. In India, this tendency is found to be very eloquent in the case of centrally sponsored schemes which kept proliferating. Review committees cut them down but they again surfaced since the political executives found them to be good vote catching devices. It could be seen that Niskanen is addressing the American context. British reaction was that Niskanen is too harsh on the bureaucracy. Largely agreeing with many of Niskanen's assumptions, Patrick Dunleavy, a British economist, discards the particular assumption that bureau's behaviour coincides with preferences of the senior-most bureaucrat. In his view, no individual has complete hegemony or autonomy. The interaction of self-regarding maximising individuals may not necessarily lead to budget maximising.

An alternative model, known as the 'budget-shaping model', was proposed by Patrick Dunleavy in 1991. This model admitted that bureaucracy might also work in small bureaus with lean staff and recommending 'agencification' or off-loading functions to private contractors or outright privatisation. Whether as a reaction to Niskanen's negative caricature of bureaucracy or as a response to Dunleavy's positive view or general refrain to minimal government, proliferation of government seems to be halting and many public-private partnerships are now happening all over the globe. In fact, both the tendencies i.e. proliferating departmental budget and agencification have been witnessed in last few decades.

13.3.3 Revenue Maximisation

There is another public choice proposal (named as the 'leviathan model') which considers State as a big monopoly. Thomas Hobbes used the word 'leviathan' to imply that the state is all powerful. James Buchanan, an American Nobel Laureate in Economics, also used this allegory to describe the enormous power that the

**Public Expenditure,
Debt and Deficits**

state enjoys. So long as it protects an individual and his property from others, it is fine. But if the agent itself violates, Buchanan questions: who is there to chain it? In view of this, Geoffrey Brennan and James Buchanan [in their book *The Power to Tax* (1980)] present the government as a revenue maximising monopolist. They argue that the tax-payer citizens can constrain the government only through fiscal constitution. Wicksell also suggests that expenditure proposals should be tied with the taxes that would finance them so as to serve an effective check on the maximising behaviour of the state. Wicksell therefore suggested a 'balanced budget'.

Given the mobility of individuals and firms, fiscal decentralisation can set the governments competing thereby nullifying the 'leviathan monopoly'. In other words, constitutional restrictions like 'fiscal federalism' can lead to political competition and the size of government (in terms of public expenditure) can be checked. However, most countries adopt a widespread system of inter-governmental transfers. Brennan and Buchanan see this as a form of collusive agreement to circumvent the competitive power of fiscal federalism. Empirical results are however not conclusive. It asserts that the size of total public expenditure varies inversely with the number of local governments. There are cases where local governments have asserted their taxing power and the total revenue and expenditure have increased. The leviathan model assumes that all revenue is tax revenue. However, in a real life situation, debt and its servicing exist and non-tax revenue could be substantial. Government run public utilities could be treated as a case of earmarked or tied taxes.

Check Your Progress 1 [answer within the given space in about 50-100 words]

- 1) Differentiate between revenue account and capital account?

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- 2) List some non-developmental activities on which public expenditure is incurred.

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- 3) Differentiate between 'transfer payment' and 'grants'.

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4) State the principle of 'maximum social advantage'.

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5) State the objective behind Rahn's model of fixing a ceiling on public expenditure budget.

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6) How is a departmental expenditure budget determined in Niskanen's model?

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7) How would you relate the Leviathan hypothesis of revenue maximisation with public expenditure?

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8) What is Dunleavy's objection to Niskanen's model? Why?

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13.4 THEORY OF PUBLIC EXPENDITURE

There are two major theories on the pattern of public expenditure movement and explanation thereof. The basic difference between the two (carried out 100 years apart) is whether this growth is smooth or it proceeds in a step-like manner.

13.4.1 Wagner's Law (Law of Increasing Public Expenditure)

Over time, in the last couple of centuries, public expenditure has been growing in almost all advanced countries (albeit marked with fluctuations). This period in those countries is also characterised by industrialisation and temporal growth of GDP per capita as also increase in population. Adolph Wagner, a German economist and politician, observed these trends quite early in 1860s (first in Germany and later in other countries in Europe). He observed a positive long-run co-movement in the two variables: public expenditure and national income. The pace of rise in public expenditure was generally higher than economic growth. He therefore concluded that the long-run elasticity of public expenditure is above unity i.e. public expenditure is increasing absolutely as well as relatively to the economy as a whole. However, explanation on why it should be happening was needed. Wagner professed that that there would be increasing political pressure for State activities and industry would be willing to cooperate.

Though the advent of modern industrial society has been interpreted liberally as progress of civilisation, many thinkers interpret this as leading to increased state functions. Hence, Wagner's law is also called as the Law of Expanding State Activity. There would be both extensive increase (i.e. new activities) as also intensive increase (i.e. more of same activity). One example of intensive increase is defence preparedness. Extensive increase could be illustrated as more social security provisions. In other words, three main factors attributed to Wagner's proposition are: (i) expansion of social activities of the state, (ii) increase in administrative and protective actions and (iii) assumption of welfare functions. Others factors pointed out are: (i) technological and institutional changes and (ii) democratisation along with rising per capita income. In brief, therefore, social progress, income effect, rising population, urbanisation, technology, etc. (some of them on demand side and others on supply side) contribute to increasing public expenditure. In view of this, Wagner's Law is also termed as 'Law of Increasing Public Expenditure'. The law has been examined empirically for different countries, for different data sets and for different periods using different techniques. Gross public expenditure, per capita public expenditure and ratio of public expenditure to GDP have been considered as dependent and GDP or GDP per capita taken as independent. Other variants of public expenditure considered in such studies include: public consumption expenditure, expenditure of total public sector, total employment by government and companies, etc. The law is generally found to hold. Some contrary hypotheses surrounding the causation factor are indicated. This takes the form that as the governments implement counter-cyclical policies to reduce the impact of business cycles, it tends to spend more and more (i.e. as its own proportion than the growth it stimulates as proportion of GDP).

13.4.2 Peacock-Wiseman's Hypothesis (Displacement Effect Hypothesis)

Two British economists (Alan T Peacock and Jack Wiseman) examined Wagner's Law to find that Wagner missed the jumps and jerks. When one plots the ratio of

Public Expenditure to GDP against time, for a fairly long period of time like half a century, one finds that there are sudden jumps and jerks. For instance, for US, UK, Germany, France and Japan, one would find two sudden and big jumps during 1914-18 and 1939-1944 besides several small jerks. They therefore suggest that a social upheaval such as war causes a permanent upward shift which means when normal times return the level assumed is not the same as the pre-upheaval level. This upward shift is referred to as the 'displacement effect'. Hence, their hypothesis is also known as 'displacement effect hypothesis'.

As an explanation to the above, Peacock and Wiseman suggest that public expenditure is not so much determined by the notion of desired level but by the limits of taxation burden people are willing to bear. A divergence between people's ideas of 'desired level of expenditure' and 'tolerable tax burden' persist in normal times. However, when a social upheaval or big disturbance (such as war) takes place, this divergence gets narrowed down. When normal times return, new ideas of tolerable tax levels emerge and a new plateau of expenditure is reached. Public expenditure will again assume a constant share of gross national product but a different one i.e. higher than the one previously obtaining before the upheaval. Though the relationship between tax rates and tax yields is not very straight forward, Peacock and Wiseman accept that 'with rising real GNP per capita, tax yields with given tax rates too may rise'. As far as tolerable limits are concerned, people are concerned with rates and not total payments. With better tax yields, it is likely that the peace time plateau may have a gentle upward slope. In times of crisis, people will accept methods of raising revenue previously thought to be intolerable. At the same time, in normal times government may not feel confident to implement what they thought was desirable. After upheaval, it becomes possible for the government to implement those schemes as people are adjusted with new levels/rates of taxation. People also become conscious of their obligations which is termed as the 'inspection effect'. There is also a 'concentration effect' whereby the share of central government increases with each upheaval as the performance of stabilisation function is to be shouldered by the central government.

Peacock-Wiseman hypothesis is applied more in terms of per capita public expenditure in absolute terms and not as share of public expenditure in GDP as in Wagner's Law. This makes a direct comparison between the two difficult. However, while Wagner Law is more about a general rising tendency, Peacock-Wiseman Hypothesis concerns itself with the shift in the level (i.e. in the sense of intercept) between two peace periods interspersed with an upheaval. The shift in levels due to an upheaval is interpreted as 'structural break'. This is because, ceteris paribus, the clause of constant tastes, preferences and institutions do not hold good i.e. the parameters change.

Check Your Progress 2 [answer within the given space in about 50-100 words]

1) State Wagner's Law.

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- 2) What reasons are attributed by Wagner for public expenditure growth over time?

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- 3) What is meant by the ‘displacement effect’ in Peacock-Wiseman Hypothesis? Illustrate the events which can trigger displacement in the level of public expenditure.

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13.5 EFFICIENCY-EQUITY TRADE-OFF

The issues of efficiency and equity are at the heart of economics as generally there exist a trade-off between the two in the short run. In the long run there is no trade-off as they become complementary. A single policy instrument might not take care of both at the same time. For instance, poll tax may be efficient (as it cannot be avoided by the tax payers) but is unjust as the rich and the poor pay the same amount.

The three roles that public finance basically attempts are reallocation, redistribution and stabilisation. Stabilisation means growth rate, price inflation and unemployment rates are relatively stable. Fiscal operations along with monetary operations are the tools used to keep the economy stable. However, the three (growth rate, inflation and unemployment) do not necessarily respond in the same direction since the outcome depends on the effect of ‘combination of different policy instruments applied’. The trickle down process of growth would not be adequate from the equity angle. Hence, aligning the allocation of resources across economic and social sectors for better redistribution effect (across persons, regions and generations) is the task the government is expected to carry out. In modern times, with democratic ethos, it is expected of the government to see that outcome of its operations are efficient on the one hand and fair and just on the other.

On taxation side, in the case of direct taxation, most governments have progressive direct taxes. However, in low income countries, the share of direct taxes is relatively low. Hence, given the size of resources available with the government, public expenditure has to be judiciously divided between economic sectors which push efficiency of the economy [e.g. infrastructure, transport, power, telecommunications, social sectors (education, health, nutrition), and social security]. Education and health typically improve life outcomes and promote both intra-generational and inter-generational equity. Within education,

though promoting lower end of education is important from the point of view of equity, higher education is important for infusing dynamic efficiency to the economy. Likewise, within health, better resources for primary health are needed to be devoted. At the same time, welfare of rising old population should not get neglected. It is argued that local efficiency gains by better execution of the programmes could contribute to improving equity outcomes.

Social security, as a pure transfer mechanism is an important equity instrument whose size is increasing in all the countries with improvement in their resources. However, a weakness of pure transfer is that there is a dead-weight loss in the redistribution transfers from the rich to the poor. This is in the sense of Okun (1975) who, by putting forward the 'leaky bucket' proposition argued that any pecuniary unit transferred from a richer individual to a poorer individual, will result in a far smaller increase in the income of the recipient than the amount of money actually transferred. Four reasons, as a result of redistribution, are suggested by Okun for this leakage: (i) the administrative costs, (ii) changes in work effort induced, (iii) changes in savings and investment behaviour and (iv) changes in attitudes (e.g. motivation to acquire human capital). The result is that government efforts to achieve equity inevitably result in a smaller level of increase in total income and less efficient use of resources.

Check Your Progress 3 [answer within the given space in about 50-100 words]

- 1) Illustrate with examples how efficiency might not promote equity.

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- 2) What is meant by the 'leaky bucket' proposition put forward by Okun?

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- 3) How does enhancing efficiency in social security expenditure enables improving equity?

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13.6 LET US SUM UP

The unit begins by providing a classification of public expenditure based on economic and functional perspectives. The rationale behind the concepts of 'maximum social advantage', 'budget maximisation' and 'revenue maximisation' are then outlined to bring out how much public expenditure is actually desirable and what are the limitations of realising it. Following this, two theories of public expenditure, attributed to Wagner and Peacock-Wiseman, are explained. Literature on empirical verification has progressed by analysing rise in per capita public expenditure both in absolute amount (at constant prices) as well as relative to GDP. Two major hypotheses that have been tested in these studies relate to whether increase in public expenditure is 'smooth' or it takes place in a 'step-like jumpy' manner. This is also the underlying argument made by Wagner and Peacock-Wiseman in their respective theories developed. Efficiency-equity trade-off in determining the size and direction of public expenditure requires that infrastructure and social sectors should be given priority thrust. Such efficiency gains by running social programmes makes for far more improved equity outcomes than direct income transfers which in many cases result in killing the motivation of beneficiaries to learn and work.

13.7 KEY WORDS

- Capital Account** : An account in government budget which deals with transactions related with assets and liabilities.
- Development Expenditure** : Expenditure incurred on such heads which directly help in resulting in improvement in economic or social aspects of people. They include sectoral spending on agriculture, irrigation, industry, mines, transport, communication, education and health.
- Leaky Bucket** : A phenomenon whereby amount in the hands of the poor beneficiary under social security scheme is significantly less than the amount actually transferred.
- Public Choice** : An approach to 'public finance' in which government and agents of government are considered as self-interested as anybody else.
- Revenue Account** : Current account dealing with transactions that have no long run implications like consumption and transfer on the side of disbursement, and tax and non-tax revenues and grants on the side of receipts.

13.8 SOME USEFUL BOOKS

- 1) David N. Hyman, *Public Finance, A Contemporary Application of Theory to Policy*, South Western Cengage Learning.
- 2) Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice*, McGraw- Hill.
- 3) S.K. Singh, *Public Finance in Theory and Practice*, S. Chand, Latest Edition.

13.9 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

- 1) Revenue account deals with current receipts and current expenditure of a government while capital accounts deals with assets and liabilities position of the government.
- 2) All essential and original activities of the State, like defence, police, judiciary, currency, foreign relations, fiscal services, currency, etc.
- 3) Transfer payments are directly made to the public for ensuring their welfare or helping them in times of distress whereas grants are usually given to a government or an agency for a purpose, project or programme.
- 4) It is the level of expenditure where $MSB = MSC$ or $NSB = 0$
- 5) With the growth of the economy, there is a rise in GDP.
- 6) By top bureaucrat in a department who is considered interested in maximising the departmental budget.
- 7) Leviathan hypothesis is basically monopolist's revenue maximisation model. As a monopolist, government determines the price of its services and thereby the expenditure of government.
- 8) Dunleavy suggests that top bureau cannot decide everything. Bureaucrats may like to shape their bureaus and in the process agencify many public services. But bureaucracy can sometimes work efficiently with smaller staff for which no credit is given by Niskanen.

Check Your Progress 2

- 1) Pace of growth of public expenditure has long run tendency to exceed that of the growth of the economy.
- 2) In progressive industrial society there is a political pressure for demand creation and industry would be willing to accommodate it by increasing the supply.
- 3) With social upheaval, there is a marked jump in public expenditure. By the time disturbance subsides, people would get accustomed to higher taxes with a 'new tolerance limit'. Besides national level wars, local wars, major natural disasters, recessions, widespread famines, etc. also account for social upheavals.

Check Your Progress 3

- 1) Poll tax is a case where maximum intended revenue can be collected but it is iniquitous.
- 2) Resources spent through transfer from the rich to the poor do not reach in same measure due to substantial loss on the way i.e. administrative costs.
- 3) By serving better and/or more beneficiaries who are poor. By enabling them to take part in the growth through an enhancement of their capacity building or capabilities.