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Lecture#3: Principles of government finance

Tashkent

What Is Public Finance?

- **Public Finance**, field of economics concerned with how governments raise money, how that money is spent, and the effects of these activities on the economy and on society

What Is Public Finance?

- **Public finance** studies how governments at all levels—national, state, and local—provide the public with desired services and how they secure the financial resources to pay for these services.

What Is Public Finance?

- In many industrialized countries, spending and taxation by the government form a large portion of the nation's total economic activity.
- For example, total government spending in the United States equals about 40 percent of the nation's gross domestic product

Why Public Finance Is Needed?

- Governments provide *public goods*—government-financed items and services such as roads, military forces, lighthouses, and street lights.
- Private citizens would not voluntarily pay for these services, and therefore businesses have no incentive to produce them.

Why Public Finance Is Needed?

- Public finance also enables governments to correct or offset undesirable side effects of a market economy.
- These side effects are called *spillovers* or *externalities*.
- Example: households and industries may generate pollution and release it into the environment without considering the adverse effect pollution has on others.

Why Public Finance Is Needed?

- Pollution is a spillover because it affects people who are not responsible for it.
- To correct a spillover, governments can encourage or restrict certain activities.
- For example, governments can sponsor recycling programs to encourage less pollution, pass laws that restrict pollution, or impose charges or taxes on activities that cause pollution.

Why Public Finance Is Needed?

- Public finance provides government programs that moderate the incomes of the wealthy and the poor.
- These programs include social security, welfare, and other social programs.
- For example, some elderly people or people with disabilities require financial assistance because they cannot work.

Why Public Finance Is Needed?

- Governments redistribute income by collecting taxes from their wealthier citizens to provide resources for their needy ones.
- The taxes fund programs that help support people with low incomes.

Public Spending

- Each year national, Provincial, and local governments create a budget to determine how much money they will spend during the upcoming year.
- The budget determines which public goods to produce, which spillovers to correct, and how much assistance to provide to financially disadvantaged people.

Public Spending

- The chief administrator of the government—such as the prime minister, governor, or mayor—proposes the budget.
- The legislature—such as the parliament, Provincial council, or Municipality council—ultimately must pass the budget.
- The legislature often changes the size and composition of the budget, but it must not make changes that the chief administrator will reject and veto.

Government Spending

- Government spending takes two forms:
- ***Exhaustive spending***
- ***Transfer spending***.

Government Spending

- **Exhaustive spending:** refers to purchases made by a government for the production of public goods.
- For example, to construct a new harbor the government buys and uses resources from the economy, such as labor and raw materials.

Government Spending

- **Transfer spending** when government transfers income to people to help them support themselves.
- Transfers can be one of two kinds:
- ***cash*** **or** ***in-kind***.
- **Cash transfers** are cash payments, such as social security checks and welfare payments.
- **In-kind transfers** involve no cash payments but instead transfer goods or services to recipients. Examples of in-kind transfers include food stamp coupons and Medicare.

Public Revenue

- Governments must have funds, or revenue, to pay for their activities.
- Governments generate some revenue by charging fees for the services they provide, such as entrance fees at national parks or tolls for using a highway.
- However, most government revenue comes from taxes, such as income taxes, *capital taxes*, and *sales* and *excise taxes*.

Public Revenue

- An important source of tax revenue in most industrialized countries is the income or payroll tax, also known as the *personal income tax*.
- Income taxes are imposed on labor or activities that generate income, such as wages or salaries.
- In the United States, income taxes account for about half of the total revenue of local, state, and federal governments combined.

Public Revenue

- Another important source of government revenue is the capital tax.
- Capital includes items or facilities that generate profits, such as factories, business machinery, and real estate.
- Some types of capital taxes are known as "profits" taxes.
- One kind of capital tax used by the federal government in the United States is the *corporate income tax*.
- A *property tax* is a capital tax used by state and local governments. Property taxes are levied on items such as houses or boats.

Public Revenue

- Sales and excise taxes are also a major source of government tax revenue.
- Many state and local governments levy a sales tax on the purchase of certain items.
- Consumers usually pay a percentage of the sales price as the tax.
- Excise taxes are used by all levels of government.
- An excise tax is levied on a specific product, such as alcohol, cigarettes, or gasoline.

- In Canada and many European, South American, and Asian countries, a *value-added tax (VAT)* provides significant revenue.
- The VAT is levied on the value added to a product during production as its components are assembled into final goods.
- For example, a clothing manufacturer might spend $500 on fabric, thread, zippers, and other goods required to make dresses. The manufacturer then adds $1000 to cover the costs of labor and the use of machines and equipment and sells the dresses for a total of $1500. The value-added tax is paid on this $1000.

How Public Finance Affects the Economy?

- Government spending and taxation directly affect the overall performance of the economy.
- For example, if the government increases spending to build a new highway, construction of the highway will create jobs. Jobs create income that people spend on purchases, and the economy tends to grow.
- The opposite happens when the government increases taxes. Households and businesses have less of their income to spend, they purchase fewer goods, and the economy tends to shrink.

Fiscal Policy

- A government's fiscal policy is the way the government spends and taxes to influence the performance of the economy.

Government Deficits

- When the government spends more than it receives, it runs a *deficit*.
- Governments finance deficits by borrowing money.
- Deficit spending—that is, spending funds obtained by borrowing instead of taxation—can be helpful for the economy.

Example

- when unemployment is high, the government can undertake projects that use workers who would otherwise be idle.
- The economy will then expand because more money is being pumped into it.
- However, deficit spending also can harm the economy.
- When unemployment is low, a deficit may result in rising prices, or inflation. The additional government spending creates more competition for scarce workers and resources and this inflates wages and prices