Public Finance: Introduction

What Is Public Finance?

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

- **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.

Significance of Public Finance

- In many industrialized countries, spending and taxation by the government form a large portion of the nation's total economic activity.
- Example: total government spending in the United States equals about 40 percent of the nation's GDP.

The role of public sector, and its financial tasks, will never end…

- 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.
- 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.
- 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. Example: Some elderly people or people with disabilities require financial assistance because they cannot work.

The scope of public finance: What the governments do…

1. **Fiscal Policy**:

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

2. **Monetary Policy:**

The government has fundamental tasks of encouraging national productivity by manipulating money supplies, controlling inflation, and stabilizing exchange rates.

Fiscal Policy and 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.

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.*

Income Tax

- 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.

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.

Sales & Excise Tax

- Sales and excise taxes are also a major source of government tax revenue.
- In Canada and many European, South American, and Asian countries, a *value-added tax (VAT)* provides significant 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.

Government Spending

Two forms:

- ***Exhaustive spending*:** refers to purchases made by a government for the production of public goods. Example: to construct a new harbor the government buys and uses resources from the economy, such as labor and raw materials.
- ***Transfer spending:*** when government transfers income to people to help them support themselves. Two types of transfer spending:
  1. **Cash transfers** are cash payments, such as social security checks and welfare payments.
  2. **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.

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.

How does deficit spending work?

- 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.