

# Components of Public Finance and Public Debt Management

Mackenzie Scott

Department of Economics and Business Economics

University of Dubrovnik

Email: [mackenzies63@gmail.com](mailto:mackenzies63@gmail.com) (Author of Correspondence)

Croatia

## Abstract

Economics & Public Finance support topic page covers issues such as macroeconomic stability, fiscal policy, economic growth, public debt, public finance management (including procurement), financial accountability as well as their practical implications for development programmers, in particular budget support operations but also technical cooperation projects.

**Keywords:** Finance; Tax, Public Debt; Management.

## **1. Introduction**

Public finance is the management of a country's revenue, expenditures, and debt load through various government and quasi-government institutions. This guide provides an overview of how public finances are managed, what the various components of public finance are, and how to easily understand what all the numbers mean. A country's financial position can be evaluated in much the same way as a business' financial statements. Public finance is the study of the role of the government in the economy. It is the branch of economics which assesses the government revenue and government expenditure of the public authorities and the adjustment of one or the other to achieve desirable effects and avoid undesirable ones. The purview of public finance is considered [by whom?] to be threefold: governmental effects on (1) efficient allocation of resources, (2) distribution of income, and (3) macroeconomic stabilization.

## **2. Components of Public Finance**

The main components of public finance include activities related to collecting revenue, making expenditures to support society, and implementing a financing strategy (such as issuing government debt). The main components include:

### ***2.1. Tax Collection***

Tax collection is the main revenue source for governments. Examples of taxes collected by governments include sales tax, income tax (a type of progressive tax), estate tax, and property tax. Other types of revenue in this category include duties and tariffs on imports and revenue from any types of public services that are not free.

### ***2.2. Budget***

The budget is a plan of what the government intends to have as expenditures in a fiscal year. In the U.S., for example, the president submits to Congress a budget request, the House and Senate create bills for specific aspects of the budget, and then the President signs them into law. Read a copy of 2017 Budget of the U.S. government, as published by the Office of Management and Budget.

### ***2.3. Expenditures***

Expenditures are everything that a government actually spends money on, such as social programs, education, and infrastructure. Much of the government's spending is a form of income or wealth redistribution, which is aimed at benefiting society as a whole. The actual expenditures may be greater than or less than the budget.

## **2.4. Deficit/Surplus**

If the government spends more than it collects in revenue there is a deficit in that year. If the government has less expenditures than it collects, there is a surplus.

## **2.5 National Debt**

If the government has a deficit (spending is greater than revenue), it will fund the difference by borrowing money and issuing national debt. The U.S. Treasury is responsible for issuing debt, and when there is a deficit, the Office of Debt Management (ODM) will make the decision to sell government securities to investors.

## **2.6 Managing Public Finance**

Let's take a closer look at how taxes, expenditures, and the deficit work. Below is a diagram of how the three are connected, and how the government determines how much financing it needs in a given fiscal year.

## **2.7 Public finance management**

Collection of sufficient resources from the economy in an appropriate manner along with allocating and use of these resources efficiently and effectively constitute good financial management. Resource generation, resource allocation and expenditure management (resource utilization) are the essential components of a public financial management system.

## **3. The Public Debt**

The public debt is how much a country owes to lenders outside of itself. These can include individuals, businesses, and even other governments. The term "public debt" is often used interchangeably with the term sovereign debt.

Public debt usually only refers to national debt. But some countries also include the debt owed by states, provinces, and municipalities. Therefore, be careful when comparing public debt between countries to make sure the definitions are the same.

Regardless of what it's called, public debt is the accumulation of annual budget deficits. It's the result of years of government leaders spending more than they take in via tax revenues. A nation's deficit affects its debt and vice-versa.

### **3.1 Public Debt versus External Debt**

Don't confuse public debt with external debt. That's the amount owed to foreign investors by both the government and the private sector. Public debt affects external debt, because if interest rates go up on the

public debt, they will also rise for all private debt. That's one reason businesses pressure their governments to keep public debt within a reasonable range.

### ***3.3 When Public Debt Is Good***

In the short run, public debt is a good way for countries to get extra funds to invest in their economic growth. Public debt is a safe way for foreigners to invest in a country's growth by buying government bonds.

Governments tend to take on too much debt because the benefits make them popular with voters. Therefore, investors usually measure the level of risk by comparing debt to a country's total economic output, known as gross domestic product (GDP). The debt-to-GDP ratio gives an indication of how likely the country can pay off its debt. Investors usually don't become concerned until the debt-to-GDP ratio reaches a critical level.

## **4. Taxation in Bangladesh**

### ***4.1 Tax (definition)***

To tax is to impose a financial charge or other levy upon a taxpayer (an individual or legal entity) by a state or the functional equivalent of a state such that failure to pay is punishable by law.

### ***4.2 Tax Classifications***

#### **4.2.1 Direct tax**

A direct tax is a form of tax is collected directly by the government from the persons who bear the tax burden. Taxable individuals file tax returns directly to the government. Examples of direct taxes are corporate taxes, income taxes, and transfer taxes.

#### **4.2.2 Indirect tax**

An indirect tax is a form of tax collected by mediators who transfer the taxes to the government, and also perform functions associated with filing tax returns. The customers bear the final tax burden. Examples of indirect taxes are sales tax and value added tax (VAT).

There are other types of taxes, which may either be direct tax or indirect taxes, including capital gains tax, corporation tax, consumption tax, inheritance tax, property tax, excise duty, retirement tax, tariffs, wealth tax or net worth tax, toll tax, and poll tax.

### ***4.3 Purposes and Effects***

Money provided by taxation have been used by states and their functional equivalents throughout history to carry out many functions. Some of these include expenditures on war, the enforcement of law and public order,

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protection of property, economic infrastructure (roads, legal tender, enforcement of contracts, etc.), public works, social engineering, and the operation of government itself. Governments also use taxes to fund welfare and public services. These services can include education systems, health care systems, and pensions for the elderly, unemployment benefits, and public transportation. Energy, water and waste management systems are also common public utilities. Colonial and modernizing states have also used cash taxes to draw or force reluctant subsistence producers into cash economies.

Governments use different kinds of taxes and vary the tax rates. This is done to distribute the tax burden among individuals or classes of the population involved in taxable activities, such as business, or to redistribute resources between individuals or classes in the population. Historically, the nobility were supported by taxes on the poor; modern social security systems are intended to support the poor, the disabled, or the retired by taxes on those who are still working. In addition, taxes are applied to fund foreign aid and military ventures, to influence the macroeconomic performance of the economy (the government's strategy for doing this is called its fiscal policy – see also tax exemption), or to modify patterns of consumption or employment within an economy, by making some classes of transaction more or less attractive.

### **5. The Four “R”s**

Taxation has four main purposes or effects: Revenue, Redistribution, Repricing, and Representation.

The main purpose is revenue: taxes raise money to spend on armies, roads, schools and hospitals, and on more indirect government functions like market regulation or legal systems.

A second is redistribution. Normally, this means transferring wealth from the richer sections of society to poorer sections.

A third purpose of taxation is repricing. Taxes are levied to address externalities: tobacco is taxed, for example, to discourage smoking, and a carbon tax discourages use of carbon-based fuels.

A fourth, consequential effect of taxation in its historical setting has been representation. The American revolutionary slogan “no taxation without representation” implied this: ruler's tax citizens, and citizens demand accountability from their rulers as the other part of this bargain. Studies have shown that direct taxation (such as income taxes) generates the greatest degree of accountability and better governance, while indirect taxation tends to have smaller effects.

#### **5.1 Tax Incidence**

Law establishes from whom a tax is collected. In many countries, taxes are imposed on business (such as corporate taxes or portions of payroll taxes). However, who ultimately pays the tax (the tax “burden”) is

determined by the marketplace as taxes become embedded into production costs. Depending on how quantities supplied and demanded vary with price (the “elasticities” of supply and demand), a tax can be absorbed by the seller (in the form of lower pre-tax prices), or by the buyer (in the form of higher post-tax prices). If the elasticity of supply is low, more of the tax will be paid by the supplier. If the elasticity of demand is low, more will be paid by the customer. And contrariwise for the cases where those elasticities are high. If the seller is a competitive firm, the tax burden flows back to the factors of production depending on the elasticities thereof; this includes workers (in the form of lower wages), capital investors (in the form of loss to shareholders), landowners (in the form of lower rents) and entrepreneurs (in the form of lower wages of superintendence).

To illustrate this relationship, suppose the market price of a product is \$1.00, and that a \$0.50 tax is imposed on the product that, by law, is to be collected from the seller. If the product has an elastic demand, a greater portion of the tax will be absorbed by the seller. This is because goods with elastic demand cause a large decline in quantity demanded for a small increase in price. Therefore in order to stabilize sales, the seller absorbs more of the additional tax burden. For example, the seller might drop the price of the product to \$0.70 so that, after adding in the tax, the buyer pays a total of \$1.20, or \$0.20 more than he did before the \$0.50 tax was imposed. In this example, the buyer has paid \$0.20 of the \$0.50 tax (in the form of a post-tax price) and the seller has paid the remaining \$0.30 (in the form of a lower pre-tax price).

## **6. Types of Taxes**

### ***6.1 Paying Taxes***

Taxes are monies paid by citizens and residents to federal, state, and local governments. The money collected from these taxes help fund for services provided by the government. It is the one of the main sources of government revenue. Types of taxes include income tax, sales tax, and property tax.

### ***6.2 Income Tax***

These are paid on a federal level and in some cases to state or local governments as well. “Taxable income” is essentially money obtained through wages, self-employment, and tips and from things like sale of property. The large majority of people pay their income taxes by having the money withheld from their paychecks. The proportion of income tax an individual is required to pay will vary according to earnings. Income tax rates are generally lower for those who make less money. However, any individual who earns an income, live in the United States and satisfies certain criteria is needed to file a tax return and also pay any taxes that they owe.

### ***6.3 Social Security and Medicare taxes***

These types of taxes are usually withheld from your paycheck. Social security benefits are provided for retired workers and their families, for disabled workers and their families and also for certain family members of deceased workers. Medicare (healthcare) taxes provides for medical services (this applies for people aged 65 and above). In the large majority of cases, a will qualify for Social Security retirement benefits and Medicare benefits after having served a period of 10 years (or 40 quarters) over the course of your life. However, in the case of disability benefits for you or your family it is likely that you will require less than 10 years of work depending on your earnings.

### ***6.4 Sales Taxes***

Sales taxes are more or less state or local taxes and usually added to the buying cost of certain things. These taxes will be based on the cost of items and help fund for services provided by state and local government, such as roads, police, and firefighters.

### ***6.5 Property Taxes***

These are also state and local taxes that are charged on your home and land. In most situations, these property taxes contribute to funding of local public schools and other services in the area person.

This is a concept summary. It aims to show how different types of taxes are categorized, and to highlight the strong and weak points of each type.

Government is supported by resources drawn from the economy. In return, government protects the economy from foreign and domestic enemies, undertakes large-scale infrastructure works of general benefit, and enforces the rights, obligations and bargains necessary for economic activity in a civil society. In modern industrial society, a tax either claims a portion of the flow of value in economic transactions between people, or takes a part of someone's accumulated stock of economic value.

## **7. Externalities**

In economics, an externality is the cost or benefit that affects a party who did not choose to incur that cost or benefit. Externalities often occur when a product or service's price equilibrium cannot reflect the true costs and benefits of that product or service. This causes the externality competitive equilibrium to not be a Pareto optimality.

### ***7.1 Positive Externalities***

When markets are functioning well, all the costs and benefits of a transaction for a good or service are absorbed by the buyer and seller. For example, when you buy a doughnut at the store, it's reasonable to assume all the costs and benefits of the transaction are contained between the seller and you, the buyer. However, sometimes, costs or benefits may spill over to a third party not directly involved in the transaction. These spillover costs and benefits are called externalities. A negative externality occurs when a cost spills over. A positive externality occurs when a benefit spills over. So, externalities occur when some of the costs or benefits of a transaction fall on someone other than the producer or the consumer.

### ***7.2 Negative Externalities***

Imagine there's a factory in your town that produces widgets, a good that benefits consumers all over the world. The smokestacks at the factory, however, belch out pollution 24/7. From an economic perspective, the firm is shifting some of its cost of production to society. How? Well, in its production process the firm uses clean air—a resource it does not pay for—and returns polluted air to the atmosphere, which creates a potential health risk to anyone who breathes it. If the firm were paying the full cost of production, it would return clean air to the atmosphere. Instead, if society wants clean air, society must pay to clean it. So, in this case, pollution represents the shifting of some of the cost of production to society, a negative externality. And, because the firm isn't paying the full cost of producing widgets, the price charged for widgets is artificially low. Consumers will buy more widgets at the artificially low price than at a price that reflects their full production cost. So, ultimately, more widgets are produced than would be the case if all costs were included. And since more widgets are being produced, more air is being polluted.

### ***7.3 Encouraging Positive Externalities***

Government can play a role in encouraging positive externalities by providing subsidies for goods or services that generate spillover benefits. A government subsidy is a payment that effectively lowers the cost of producing a given good or service. Such subsidies provide an incentive for firms to increase the production of goods that provide positive externalities. And, because the spillover benefits go to society, government subsidies are a way for society to share in the cost of generating positive externalities. After all, society pays the taxes that fund the subsidies. Regarding education, because the government subsidizes public education, a greater quantity of education is produced and consumed and society reaps the spillover benefits.

### ***7.4 Positional***

A position externality "occurs when new purchases alter the relevant context within which an existing positional good is evaluated. "Robert H. Frank gives the following example

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If some job candidates begin wearing expensive custom-tailored suits, a side effect of their action is that other candidates become less likely to make favorable impressions on interviewers. From any individual job seeker's point of view, the best response might be to match the higher expenditures of others, lest her chances of landing the job fall. But this outcome may be inefficient since when all spend more, each candidate's probability of success remains unchanged. All may agree that some form of collective restraint on expenditure would be useful."

Frank notes that treating positional externalities like other externalities might lead to "intrusive economic and social regulation." He argues, however, that less intrusive and more efficient means of "limiting the costs of expenditure cascades"—i.e., the hypothesized increase in spending of middle-income families beyond their means "because of indirect effects associated with increased spending by top earners"—exist; one such method is the personal income tax.

### ***7.5 Inframarginal***

Inframarginal externalities are externalities in which there is no benefit or loss to the marginal consumer. In other words, people neither gain nor lose anything at the margin, but benefits and costs do exist for those consumers within the given inframarginal range.

### ***7.6 Technological***

Technological externalities directly affect a firm's production and therefore, indirectly influence an individual's consumption; and the overall impact of society.

### ***7.7 Externalities and Efficiency***

Why do externalities pose problems for resource allocation in a market system? Unregulated competitive markets result in prices that equal the marginal costs and marginal benefits that sellers incur and buyers enjoy. When an externality exists, the marginal costs or marginal benefits that market participants base their decisions on diverge from the actual marginal social costs or benefits. For example, with a negative externality, business firms producing a product for sale in the marketplace neither pay for nor consider the damage the production or consumption of that product can do to the environment. Similarly, with a positive externality, buyers and sellers of a product in the marketplace do not consider the fact that their production or consumption of the item benefits third parties. Once this is understood, we can look at alternative government policies to correct resource allocation problems that result from externalities.

## 8. Resource Mobilization

Resource mobilization is the process of getting resources from resource provider, using different mechanisms, to implement an organization's pre-determined goals.

It deals in acquiring the needed resources in a timely, cost-effective manner. Resource mobilization advocates having the right type of resource, at the right time, at right price with making right use of acquired resources thus ensuring optimum utilization of the same.

It is a major sociological theory in the study of social movements which emerged in the 1970s. It emphasizes the ability of a movement's members to 1) acquire resources and to 2) mobilize people towards accomplishing the movement's goals. In contrast to the traditional collective behavior theory that views social movements as deviant and irrational, resource mobilization sees them as rational social institutions, created and populated by social actors with a goal of taking political action.

## 9. Conclusion

Underdeveloped nations are keen on rapid economic development which requires huge expenditure to be incurred in the various sectors of the economy.

The private sector is either unable to find and invest these huge amounts or it is unwilling because the return from such investments may be uncertain or long delayed.

Hence, economic development has to depend almost entirely on public expenditure. Public finance, therefore, plays capital role in economic development of an under-developed economy.

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