

PUBLIC FINANCE

Three principles that public finance is based on are:

Non-optional

Non-refundable

Non-equivalent

Non-optional

Economic entities are **forced** by law to contribute to **the joint budget** of national or local authorities. Although the entities must contribute, they are not guaranteed a sufficient amount of public goods.

Taxation being **compulsory contributions** from individuals, or business entities to the government to defray the public expenditures by the government has some effects in the economy as well as in the social life of the society.

Non-refundable

The imposition of tax should yield the expected revenues in order to assist government **forward planning**. However, these collected revenues **are not directly refunded** to the tax payers.

Non-equivalent

Although the entities contribute to a **joint fund**, the benefit from it expended by them is not equivalent.

Simply, **poor households** contribute little, but the goods provided for them by the public sector are relatively large. With regards to **rich households**, the situation is reverse.

Taxation: Evaluating Revenue Sources

Taxation

- The only method to share burden of provision of public goods.
- May also be used to share cost of common-pool and toll goods.
- Only socially acceptable way to re-distribute wealth.

- The levying of taxes requires coercive authority
- For this reason, government must be careful when it comes to designing and implementing tax systems.

Criteria for designing a good tax system

- Equity
- Economic efficiency
- Collection costs (to collector & to society)
- Revenue consequences

Equity

- **Distribution according to benefits**
- **Distribution according to ability to pay**

Note: Distribution according to benefits is impractical for public goods.

How is ability to pay defined/measured?

- **Property**
- **Income**
- **Net wealth**

Horizontal Equity: Everyone with the same ability to pay pays equal amount.

Vertical Equity: Concerns proper relationship between tax burdens of individuals with different capabilities to pay.

➤ **Redistribution issue**

- **Regressive:** People with greater ability to pay, pay proportionately less.
- **Proportional:** People pay same proportion (of income, wealth, etc.)
- **Progressive:** People with greater ability to pay, pay proportionately more.

Is there an economic justification for a progressive tax structure?

Diminishing marginal utility argument: Low-income individuals value additional unit of income **more** than high-income individuals.

Progressive tax structure increases overall social welfare.

Who really pays? (Tax incidence)

Taxpayer may be able to shift some or all of the cost of a tax to someone else.

- **Forward shift:** Shift to consumers—increase prices.
- **Backward shift:** Shift to suppliers—reduce prices paid to them.

Stability of tax system

- Cyclical stability of tax base

Tax diversification:

1. Personal income taxes
2. Property taxes
3. General sales or value added taxes
4. Excises
5. Corporate profit taxes

- Revenue (adequacy) stability

Economic growth = growth in demand for services. Need revenue sources that also expand with income.

Transparency

An effective tax system must be transparent

- **Adoption:** Taxes must be adopted by legitimate process.
- **Administration:** Tax collection criteria must be objective, explicit, knowable, and fair.
- **Compliance requirements:** How tax is to be calculated should be clear to everyone.
- **Amount of payment:** Taxpayers should know how much tax they are paying and to whom they are paying it.

Economic Effects

1. **Work vs. leisure:** High marginal rates may induce a preference for leisure.
2. **Business operations:** Taxes should not (generally) affect business practices.
3. **Shopping and business location:** Sales taxes and excises may affect shopping patterns and business location.
4. **Personal financial management:** People manage activities and finances to minimize tax burden.
5. **Investment choices:** Taxes may make less productive investments preferable.
6. **Savings:** Taxes may adversely affect decisions to save.

Taxation and Externalities

An exception to standard of neutrality for tax efficiency is to address negative externalities

- Emission taxes: Taxes on polluting emissions.
 - Direct measurement of emissions necessary
 - Apply to last link—where emissions into environment take place
- Indirect taxes on goods and services: Taxes of products and services the production of which produces social costs (pollution, health costs, social services).

Thank you