Public Finance

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.

Overview

The proper role of government provides a starting point for the analysis of public finance. In theory, under certain circumstances, private markets will allocate goods and services among individuals efficiently (in the sense that no waste occurs and that individual tastes are matching with the economy's productive abilities). If private markets were able to provide efficient outcomes and if the distribution of income were socially acceptable, then there would be little or no scope for government. In many cases, however, conditions for private market efficiency are violated. For example, if many people can enjoy the same good (the moment that good was produced and sold, it starts to give its utility to every one for free) at the same time (non-rival, non-excludable consumption), then private markets may supply too little of that good. National defense is one example of non-rival consumption, or of a public good.

"Market failure" occurs when private markets do not allocate goods or services efficiently. The existence of market failure provides an efficiency-based rationale for collective or governmental provision of goods and services.[10] Externalities, public goods, informational advantages, strong economies of scale, and network effects can cause market failures. Public provision via a government or a voluntary association, however, is subject to other inefficiencies, termed "government failure."

Under broad assumptions, government decisions about the efficient scope and level of activities can be efficiently separated from decisions about the design of taxation systems (Diamond-Mirrlees separation). In this view, public sector programs should be designed to maximize social benefits minus costs (cost-benefit analysis), and then revenues needed to pay for those expenditures should be raised through a taxation system that creates the fewest efficiency losses caused by distortion of economic activity as possible. In practice, government budgeting or public budgeting is substantially more complicated and often results in inefficient practices.

Government can pay for spending by borrowing (for example, with government bonds), although borrowing is a method of distributing tax burdens through time rather than a replacement for taxes. A deficit is the difference between government spending and revenues. The accumulation of deficits over time is the total public debt. Deficit finance allows governments to smooth tax burdens over time and gives governments an important fiscal policy tool. Deficits can also narrow the options of successor governments. There is also a difference between public and private finance, in public finance the source of income is indirect for ex:various taxes(specific taxes,value added taxes), but in private finance sources of income is direct.

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:

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 type of public services that are not free.

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.

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.

Deficit/Surplus

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

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.

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.

Total government revenue or tax collection is represented by the blue bar. This is a source of cash for the government.

Expenditures are a use of cash, and to the extent that they are greater than revenue, there is a deficit.

The difference between revenue and expenditures is the deficit (or surplus) that is funded with national debt.

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.

The following subdivisions form the subject matter of public finance.

1. Public expenditure
2. Public revenue
3. Public debt
4. Financial administration
5. Federal finance

Government expenditures

Economists classify government expenditures into three main types. Government purchases of goods and services for current use are classed as government consumption. Government purchases of goods and services intended to create future benefits – such as infrastructure investment or research spending – are classed as government investment. Government expenditures that are not purchases of goods and services, and instead just represent transfers of money – such as social security payments – are called transfer payments

Government operations

Government operations are those activities involved in the running of a state or a functional equivalent of a state (for example, tribes, secessionist movements or revolutionary movements) for the purpose of producing value for the citizens. Government operations have the power to make, and the authority to enforce rules and laws within a civil, corporate, religious, academic, or other organization or group.

Income distribution

Income distribution – Some forms of government expenditure are specifically intended to transfer income from some groups to others. For example, governments sometimes transfer income to people that have suffered a loss due to natural disaster. Likewise, public pension programs transfer wealth from the young to the old. Other forms of government expenditure that represent purchases of goods and services also have the effect of changing the income distribution. For example, engaging in a war may transfer wealth to certain sectors of society. Public education transfers wealth to families with children in these schools. Public road construction transfers wealth from people that do not use the roads to those people that do (and to those that build the roads).

Income Security

Employment insurance

Health Care

Public financing of campaigns

Financing of government expenditures

Government expenditures are financed primarily in three ways:

Government revenue

Taxes

Non-tax revenue (revenue from government-owned corporations, sovereign wealth funds, sales of assets, or seigniorage)

Government borrowing

Money creation

How a government chooses to finance its activities can have important effects on the distribution of income and wealth (income redistribution) and on the efficiency of markets (effect of taxes on market prices and efficiency). The issue of how taxes affect income distribution is closely related to tax incidence, which examines the distribution of tax burdens after market adjustments are taken into account. Public finance research also analyzes effects of the various types of taxes and types of borrowing as well as administrative concerns, such as tax enforcement.

Taxes

Taxation is the central part of modern public finance. Its significance arises not only from the fact that it is by far the most important of all revenues but also because of the gravity of the problems created by the present day tax burden.[14] The main objective of taxation is raising revenue. A high level of taxation is necessary in a welfare State to fulfill its obligations. Taxation is used as an instrument of attaining certain social objectives, i.e., as a means of redistribution of wealth and thereby reducing inequalities. Taxation in a modern government is thus needed not merely to raise the revenue required to meet its expenditure on administration and social services, but also to reduce the inequalities of income and wealth. Taxation might also be needed to draw away money that would otherwise go into consumption and cause inflation to rise.

A tax is a financial charge or other levy imposed on an individual or a legal entity by a state or a functional equivalent of a state (for example, tribes, secessionist movements or revolutionary movements). Taxes could also be imposed by a subnational entity. Taxes consist of direct tax or indirect tax, and may be paid in money or as corvée labor. A tax may be defined as a "pecuniary burden laid upon individuals or property to support the government [. . .] a payment exacted by legislative authority."[16] A tax "is not a voluntary payment or donation, but an enforced contribution, exacted pursuant to legislative authority" and is "any contribution imposed by government [. . .] whether under the name of toll, tribute, tallage, gabel, impost, duty, custom, excise, subsidy, aid, supply, or other name."

There are various types of taxes, broadly divided into two heads – direct (which is proportional) and indirect tax (which is differential in nature):

Stamp duty, levied on documents

Excise tax (tax levied on production for sale, or sale, of a certain good)

Sales tax (tax on business transactions, especially the sale of goods and services)

Value added tax (VAT) is a type of sales tax

Services taxes on specific services

Road tax; Vehicle excise duty (UK), Registration Fee (USA), Regco (Australia), Vehicle Licensing Fee (Brazil) etc.

Gift tax

Duties (taxes on importation, levied at customs)

Corporate income tax on corporations (incorporated entities)

Wealth tax

Personal income tax (may be levied on individuals, families such as the Hindu joint family in India, unincorporated associations, etc.)

Debt

Governments, like any other legal entity, can take out loans, issue bonds, and make financial investments. Government debt (also known as public debt or national debt) is money (or credit) owed by any level of government; either central or federal government, municipal government, or local government. Some local governments issue bonds based on their taxing authority, such as tax increment bonds or revenue bonds.

As the government represents the people, government debt can be seen as an indirect debt of the taxpayers. Government debt can be categorized as internal debt, owed to lenders within the country, and external debt, owed to foreign lenders. Governments usually borrow by issuing securities such as government bonds and bills. Less creditworthy countries sometimes borrow directly from commercial banks or international institutions such as the International Monetary Fund or the World Bank.

Most government budgets are calculated on a cash basis, meaning that revenues are recognized when collected and outlays are recognized when paid. Some consider all government liabilities, including future pension payments and payments for goods and services the government has contracted for but not yet paid, as government debt. This approach is called accrual accounting, meaning that obligations are recognized when they are acquired, or accrued, rather than when they are paid. This constitutes public debt.

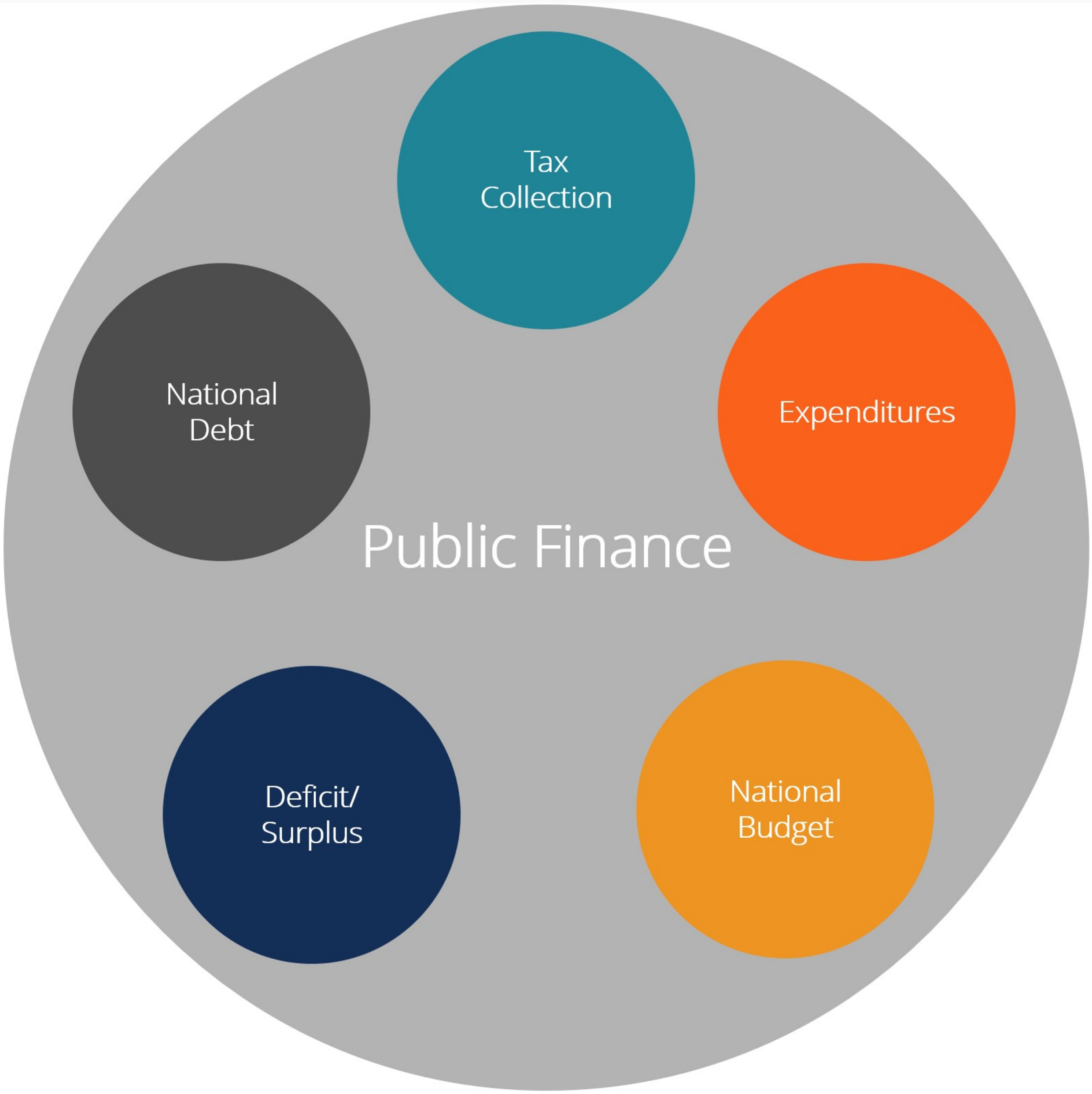
Seigniorage

Seigniorage is the net revenue derived from the issuing of currency. It arises from the difference between the face value of a coin or banknote and the cost of producing, distributing and eventually retiring it from circulation. Seigniorage is an important source of revenue for some national banks, although it provides a very small proportion of revenue for advanced industrial countries.

Public finance through state enterprise

Public finance in centrally planned economies has differed in fundamental ways from that in market economies. Some state-owned enterprises generated profits that helped finance government activities. The government entities that operate for profit are usually manufacturing and financial institutions, services such as nationalized healthcare do not operate for a profit to keep costs low for consumers. The Soviet Union relied heavily on turnover taxes on retail sales. Sale of natural resources, and especially petroleum products, were an important source of revenue for the Soviet Union.

In market-oriented economies with substantial state enterprise, such as in Venezuela, the state-run oil company PSDVA provides revenue for the government to fund its operations and programs that would otherwise be profit for private owners. In various mixed economies, the revenue generated by state-run or state-owned enterprises are used for various state endeavors; typically the revenue generated by state and government agencies goes into a sovereign wealth fund. Examples of this are the Alaska Permanent Fund and Singapore's Temasek Holdings.



Revenue and Expenditures

Below is a list of some of the most common revenues and expenditures in the world of public finance.

Revenue / Taxes

Income tax (personal, corporate)

Property tax

Sales tax

Value added tax (VAT)

Import duties

Estate tax

Expenses

Health care

Employment insurance

Pensions

Education

Defense (military)

Infrastructure

Additional Resources

Thank you for reading CFI's guide to what public finance is and how the numbers all fit together. When you look at it in simple terms, it's quite easy to understand.

CFI is the official provider of the global Financial Modeling & Valuation Analyst (FMVA)™ certification program, designed to help anyone become a world-class financial analyst. To keep advancing your career, the additional CFI resources below will be useful:

Accounting for Income Taxes

Top Accounting Scandals

Finance Salary Guide

War Bonds

Difference between Public and Private Finance

16 Major Difference between Public and Private Finance

The term "finance" is associated with revenue and expenditure. Public finance is a branch of Economics which deals with the government's revenue and expenditures of an economy. If it is related to the private sector, it is called private finance.

Finance includes those means by which we make various types of payment. It may be defined as the provision of money at the time of need. In other words, it is the arrangement of money sources and the acquisition of funds for the satisfactory conduct of business activities.

"Finance consists of providing and utilizing the money, capital rights, credit and funds of any kind which are employed in the operation of an enterprise.

George Terry

It may thus refer to investing in borrowing and spending of money with proper manners for the operation of the business.

Finance is important and essential for the success of any enterprise. Without proper finance, no business can be run smoothly. So a sufficient amount of capital must be provided in order to achieve desired results from the activities.

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Sources of Business Funds

Balance Sheet represents the amount which is supplied by the contributors. Assets are shown on the right-hand side of the balance sheet which refers to the use of funds. Liabilities are on the left side of the balance sheet which shows the sources of funds. These funds are employed temporarily by the creditors and are expected ultimately to be paid back with the sum they have advanced to the business. But owners make a permanent investment of funds to the business.

Creditors

This source of loan is obtained for short term intermediate and long period. The repayment of this loan is made on an instalment basis if it is more than one year. Creditor's fund is generally grouped into the following main titles on the liabilities side of the Balance sheet.

Accounts Payable

This is the result of the supply of goods services to the customers. No credit document is used in this kind of credit dealings.

Notes Payable

It arises from the sale of goods, the supply of services or loan of funds from the financial institution. It is represented by a written document i.e. promissory note etc.

Securities

Large size firm may issue the secured or unsecured bonds or promissory notes when various term funds are required. It is divided up among a number of creditors. Each creditor holds written evidence or promises to pay for his share of the loan on a future date.

Mortgage

It represents that the firm has accepted a loan from the commercial bank or investment bank for a long period of time against the security of building, land and machinery.

Outstanding

It refers to the accumulation of indebtedness amount up to the date of the closing books. These generally include the items which have accrued to but have not been actually paid. They represent accumulating wages, rent, salaries, interest and taxes which are found on the liabilities side of1he Balance sheet.

Owners

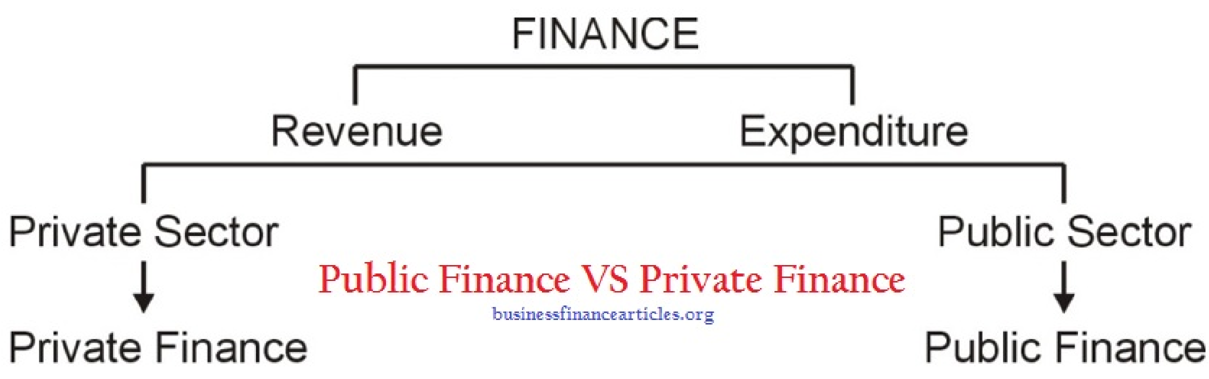
The owner's investment appears in the Balance sheet by various heads in various forms of Business Organization.

Sole Tradership

The invested amount by the owner may be increased by profit and decreased by losses and withdrawal. The owner’s interest in a sole tradership generally finds a single title in the Balance sheet.

Partnership

Owner’s interests are generally considered similar to the sole traders in Partnership. But in the partnership, the profit is distributed among the number of partners and if there is any loss, the same partners are to bear it. Therefore the owner’s interest in the partnership is not constant but it may increase or decrease at a rate varying with the profit or loss of the firm.



Differences Between Public & Private Finance

Private: It deals with revenue and expenditure of private sector.

Public: It deals with revenue and expenditure of the government sector (public sector)

Time Period

Public finance is related to one year time period whereas private finance is concerned with daily, weekly and monthly budget, etc.

Income vs Expenditure

In public, revenue follows expenditure. On the other hand, in private finance expenditure follows revenue.

Deficit Financing

In the case of the deficit budget, Govt. can issue new notes. On the other hand, the private sector has no authority to issue new notes.

Nature of Budget

In the public sector, the deficit budget is appreciable. In the private sector, the surplus budget is appreciable.

Compulsory Loans

The government can take compulsory loans from different financial institutions to meet its expenditure whereas the private sector cannot do it.

Secrecy

A government budget is no more secret, rather Govt. publicizes its budget through T.V, Radio, etc. On the other hand, the private budget is tried to be kept secret.

Nature of Projects

In public finance, Government has to complete long term projects. On the other hand, the private sector has a short terms project to complete.

Nature of changes

Public finance is concerned with remarkable changes whereas the private sector is concerned with minor changes.

Written Document

Public budget is a written document whereas the private budget is not a written document.

Audit System

Govt. revenue and expenditure is regularly checked by an audit system. On the other hand, there is no audit system in private finance.

Foreign Assistance

The Government can depend upon foreign assistance but in private finance, there is no chance of any foreign aid.

Direct or Indirect Source of Income

In public finance, the source of income is indirect i.e., various taxes whereas in private finance source of income is direct.

Prior Sanction

Govt. takes prior sanction from its cabinet, national assembly, senate, etc whereas, no prior sanction is required from any authority.

Future Planning

There is long term planning while in private finance short term planning is the motive.

Use of Financial Resources

In public, the main objective is the social welfare of the people whereas, in private resources are used just for maximum personal satisfaction.

Record of Finance

The private may or may not keep the record of its finance whereas Govt. keeps the permanent record of its finance.

Finally

We can conclude that the finance of both the private and public sectors is concerned with revenue and expenditures. Anyhow, we can differentiate private and public finance on the basis of certain grounds.