Public Financial Management: Revenue

Module Introduction and Overview

Contents

1 Introduction to the Module

This module aims to introduce you to the theory and practice of public finance, with special reference to how governments raise and use revenues. It is concerned with taxation, borrowing and aid. There are economic principles that bear on the issues of financing public expenditure and these are covered in the module. At the same time, however, we recognise that decisions on taxation, borrowing and aid are not taken solely with reference to economics but also to politics, and the module raises relevant political and social issues too. While the module has some emphasis on taxation in poorer countries, they are not its exclusive concern.

What are the important issues in public revenue?

This module is mainly about financing governments and public services. It asks how governments at national and sub-national level can finance their activities and what the impacts of those financing decisions are. It assumes that decisions have already been made about the size of the public sector. There is a discussion in the module *Public Policy and Management: Perspectives and Issues* about explanations and justifications for government activities. There it is shown that there was a growth in the proportion of national resources allocated to the public sector in the OECD countries, especially during the second half of the twentieth century. Much of the growth was accounted for by increases in the proportion of national incomes devoted to transfers from one set of citizens to another according to their stages in life and, to a lesser extent, according to their level of income.

This module is not about the highest-level strategic issue of what the public sector should or should not do and how much of the national product should be collected in taxes, although this issue cannot be entirely avoided, for example, when we look at how to correct deficits in public finances. One option is always to reduce the level of spending, and therefore choices have to be made about which activities can be cut or cancelled. The main focus on this module is on how government activities can be financed.

Raising government revenues

First, there are choices to be made about how governments should raise revenue to finance their activities. Taxation is normally the main source of revenue, except in those cases in which governments are able to collect rents for the extraction of oil and gas or minerals from their territories. A major issue for all governments is how to design and run a tax system that collects money efficiently, that is broadly acceptable to the taxpayers, that is simple to run and does not produce unacceptable inequity. The overall process is called *fiscal reform*. The strategic issue is: what is the best mix of revenue sources for government, including the practical issue of what revenues can actually be collected?

The second source of funds for government activities is borrowings. Where budget deficits occur because insufficient tax is collected to fund all of their spending, governments have either to borrow, from their own citizens or from foreigners, or to print money. Often governments continue borrowing for many years and incur large accumulated debts. Printing money to pay for public services normally leads in the medium term to high rates of inflation. The strategic issue is: how big should a deficit be, and what can governments do to contain the deficit to that level?

Local government finance

Sub-national governments have similar strategic questions, although the extent to which they can make their own choices about taxation and borrowing varies according to how centralised their systems are and how much control national governments exert on local governments' finances. The module *Decentralisation and Local Governance* deals with these questions. What local governments cannot do is print money. Apart from borrowing, taxing and central government grants, therefore, local governments often have to find ways of charging for the local services they provide. They also find ways of using their assets, especially land holdings, to raise money for projects. The issue is: what are the best ways for local governments to finance their activities?

Alternative taxation policies

Taxation policy is not only a matter of raising revenues to pay for government services. Governments also try to use the tax system and tax incidence to pursue other policies. Progressive taxation on incomes and profits is often used to redistribute income and wealth. There are also attempts to pursue environmental policies through the tax system, creating tax incentives to pollute less, both for individuals and for companies. The strategic issue is: how can policies be pursued successfully through the tax system?

Taxing for growth

Governments also use taxation as a contribution towards national competitiveness. Low levels of personal and company taxation are seen as contributing to the price competitiveness of domestic industries against foreign competitors. They are also used to attract foreign investment. If it is not possible to keep taxes low for all companies, there is the other option of creating tax breaks for companies willing to invest in a country or a region within it. Sometimes, governments create permanent tax-free zones in which trade and manufacturing can take place. The strategic issue is: do tax competition and tax incentives for inward investment produce faster economic growth?

The question of using taxation to help growth is a subset of the general issue of taxation policy for developing economies in a globalising world. Developing economies tend to have a greater reliance on indirect taxes than do rich economies. Reliance on duties on traded goods is slowly being replaced by taxes on 'value added', another form of indirect taxation.

Aid and loans

Many poorer countries are dependent to some extent on foreign aid assistance to finance their governments' expenditures. The strategic question for donors and lenders is: how to structure the aid and lending regime to produce their desired results. For recipient governments the question is similar: how can we use the aid and loans for our own ends while not jeopardising the future flow of funds?

2 The Module Author

Tony Allen is a retired university lecturer in economics and is now working as an educational consultant. He was a Principal Lecturer and Subject Leader in Economics, at the University of Westminster in London, teaching on both undergraduate and postgraduate courses. He is a graduate of the Universities of Hull, London and Brunel.

Dr Allen's research interests lie in public policy, particularly the economics of education, fiscal decentralisation and project appraisal. He has been a member of the Associate Faculty of Henley Management College (now Henley Business School, part of the University of Reading) from 1986 to 2010, contributing to their MBA programmes, and a Visiting Lecturer in Economics at the Middlesex University Business School 1994–97, teaching managerial economics on their executive MBA courses. He was also Programme External Examiner for Economics and Business Studies at the University of Hertfordshire and at INTI University College in Kuala Lumpur, Malaysia, both posts from 2006–2011.

Tony Allen has been a tutor at CeFiMS since 2003 during which time, in addition to tutoring, he has authored or revised modules in taxation, project appraisal, development assistance and decentralisation. He also contributed to a short course on fiscal decentralisation and private public partnerships in 2006 in South Africa for government finance officials.

3 Study Resources

This study guide is your central learning resource as it structures your learning unit by unit. Each unit should be studied within a week. It is designed in the expectation that studying the unit and the associated core readings will require 15 to 20 hours during the week, but this will vary according to your background knowledge and experience of studying.

There is no one key text that covers the scope of this module.

The readings provide a selection of academic articles and extracts from books and journals, which you are expected to read as part of your study of this module. You will note from reading them that the topics covered in these articles often vary widely from the study guide. The reading articles are often more technical or adopt a more in-depth approach. This should not put you off, as many were written with an academic audience in mind. These articles were selected so that the central arguments and concepts could be understood and appreciated at a level appropriate to this module.

4 Module Overview

Unit 1 Introduction to Taxation

1.1 Introduction
1.2 Criteria for Assessing Types of Taxes
1.3 Types of Tax

5 Learning Outcomes

When you have completed your study of this module you will be able to:

- outline and discuss the main sources of government revenue
- explain the main criteria for assessing types of taxation
- analyse the main trends in taxation especially as between advanced and developing countries
- evaluate the main recommendations and analytical methods of the theory of optimal taxation that underpins modern tax reform
- gauge the degree of inequality and evaluate policies to reduce inequality
- outline the economic arguments for and against environmental taxes
- assess the impact of taxes on people's consumption behaviours
- evaluate the causes of weak tax administration in developing countries and recommended appropriate policies to improve tax administration
- judge the use of Value Added Taxes in the context of developing countries
- discuss the causes and effects of tax competition between countries
- evaluate the effects of natural resource abundance on countries
- explain the economic case for fiscal decentralisation
- explain the characteristics of local taxes and some of the problems of tax collection at local level
- define the issues in how fiscal policy can be used to stabilise economies
- outline the different effects and policy implications of internal and external debt
- explain how governments can create the illusion of fiscal adjustment by financial engineering

- assess the success of aid giving as a method of supplementing government revenues in poorer countries and analyse its effects on government spending, tax raising and borrowing.