

Introduction to Public Finance

PSPA 611: Public Revenue Analysis & Financial Management

The Plan

1. Introductions, course policies, other beginning items
2. The Economics of Local Government Services
3. Legal Foundations
4. Break!
5. Principles of Revenue Analysis
6. Tax Administration

Hi, I'm new here.

Syllabus stuff

- 3 books and a 4th if you want
- This is a discussion class so you've got to participate and be here
- Two exams, one paper, and a presentation
- Course policy stuff

Why Should You Care About This Stuff?

- Helping to strengthen democratic institutions
- Helping to achieve the best possible outcomes
- Helping public organizations adapt to a changing environment

The Economics of Local Government Services

Public v. Private Goods

- Key terms
 - **Rivalry or divisibility:** The consumption of the good or service prevents simultaneous consumption by another consumer
 - **Excludability:** The benefits of the good or service can be limited to those to purchase them

Public v. Private Goods

Excludable

Non-excludable

Rivalrous

Private good

Common pool resource

Non-rivalrous

Club good

Public good

**Does local government provide
public goods?**

Why does a government intervene?

If state and local governments provide private and public goods, why do they do it?

- Market failure
- Natural monopolies
- Merit goods
- History

Market failures

- The private sector does not provide goods or services that do not yield profits
- The private sector may “cream” the easiest to serve constituents
- Just because the good or service isn't profitable, doesn't mean it isn't necessary
- Government can step in to provide such a good or service

Natural Monopolies

- Some services are highly capital intensive
- To assure the lowest possible price for the service, it is necessary to have just one producer
- This can be achieved through regulation or direct provision

Merit Goods

- Some private goods may be provided by the government because it is believed they provide significant benefits to the public
- **Example:** Education
 - Rivalrous and excludable
 - However, the benefit of higher educational attainment is important

History

- Because it always has
- Public provision may have been appropriate at one time, but now the service continues to be provided by the public because of inertia

How Can All This Be Legal?

Three legal powers in Western democracies

- Taxing
- Proprietary
- Regulatory

Taxing Powers

- Income-based taxes
- Consumption-based taxes
- Wealth-based taxes

Proprietary Powers

- The power to own and operate business enterprises
- Ex: water and sewer services, public transit, etc...
- Gives rise to fee-for-service arrangements instead of taxes

Regulatory Powers

- Sometimes referred to as police powers
- Include the power to promote the health, safety, and well-being of the community
- Can include land use regulations, licensing requirements, and inspections

The Illinois Context: Home Rule

- Ill Const. art. VII § 6
- Available for counties with an elected chief executive officer and municipalities over 25,000 in population OR by a popular referendum
- “Home rule units may exercise and perform concurrently with the State any power or function of a home rule unit to the extent that the General Assembly by law does not specifically limit the concurrent exercise or specifically declare the State’s exercise to be exclusive.”

Influences on Financial Decision-making

- Politics
- Economic environment
- Social environment
- Legal environment

Politics

- Citizen involvement
- Related: political climate

Economic Environment

- Economic cycles
- Inflation
- Interest rates
- Competition from other local governments

Social Environment

- Population changes
- Changes in the age distribution of the citizenry
- Personal income

Legal Environment

- Balanced budget requirements
- Tax and expenditure limits
- Mandates
- Combination of the three

Questions?

Break!

Principles of Revenue Analysis

- Communities have a large amount of power in setting revenue policy
- How they go about doing it says a lot about their goals/aspirations for the community

Principles of Revenue Analysis

- Fairness or equity
- Neutrality
- Effective administration

Equity

Effective Tax Rates

$$\tau = T/I$$

- Two types of equity
 - **Horizontal:** the distribution of tax burdens among persons or businesses in *comparable* circumstances
 - **Vertical:** the distribution of tax burdens among persons or businesses in *different* circumstance

Questions

- Who are in “comparable” circumstances?
- Adjustments in federal taxes — deductions and exemptions are there to promote horizontal equity
- Uniformity clauses in state constitutions (property taxes) — restricts adjustments for individual circumstances, requires all taxpayers to be treated the same

Vertical Tax Distributions

- Regressive
- Progressive
- Proportional

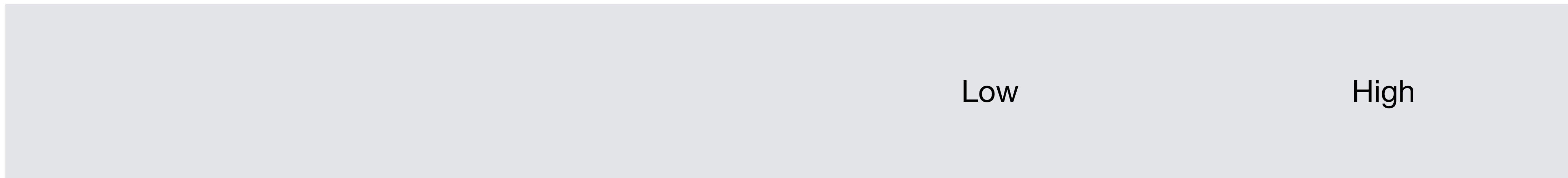
Equity in Practice

- Theories of equity provide a useful metric for evaluating tax policy; however, it does not provide any guidelines about how to design a tax policy
- Two principles
 1. Benefits-received principle
 2. Ability-to-pay principle

Equity in Practice

- Ultimately, the equity or fairness of a tax system is a political decision
- Fundamental Elements
 - A. Benefits-based taxes are the most defensible
 - B. Tax favors to individuals or groups undermine perceived fairness
 - C. Revenue policies should ease the burden on the poorest and not punish the wealthy
 - D. Tax fairness varies among communities

Revenue Effort

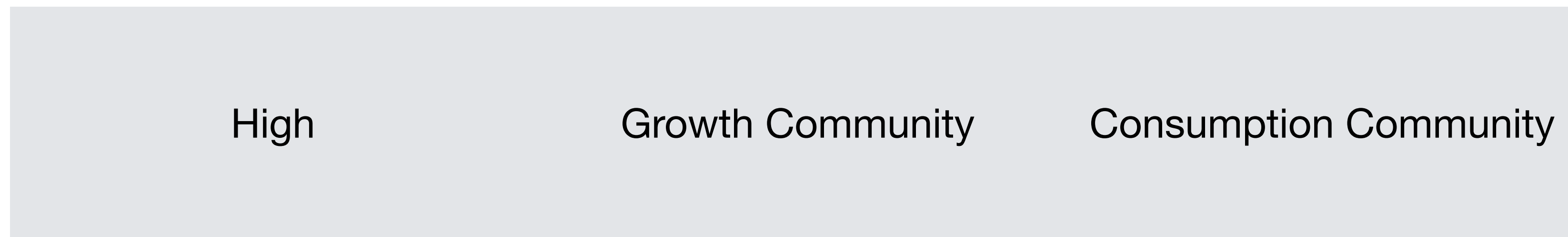


Low

Caretaker Community

Arbiter Community

Revenue Capacity



High

Growth Community

Consumption Community

Neutrality

Neutrality in Theory

- Taxes introduce inefficiencies into a perfectly competitive market
- In other words, taxes change individual's and business's behavior
- Different taxes do this to a more or less extent
- The idea is to minimize the influence on private decision making

Neutrality in Practice

- Four Basic Principles
 1. Broaden the tax base and lower the tax rate
 2. Benefits based taxes and charges interfere with the market the least
 3. Neutrality is more adversely affected by tax rate differentials than by the absolute level of taxation
 4. Particular care is required in the design of local business taxes

Broad Bases, Low Rates

- Tax incidence - Who ultimately pays the tax?
 - The law establishes who has legal liability for the tax
 - However, where the tax falls in the production process and whether market conditions allow for shifting influence who actually pays
 - Ultimately, the consumer ends up paying nearly all taxes

Benefits Taxes

- Act similar to prices so they do not influence the neutrality of the tax

Tax Differentials

- Inter-jurisdictional differences in rates are noticeable
- People and businesses may be sensitive to these differences when choosing where to live/locate
- Border effects with consumption and income based taxes

Business Taxes

- Not really advisable outside of benefits taxes
- Levy taxes only on final products
- Keep them in line with neighbors or region

Tax Administration



Notification

- Notification of tax liability
 - Indirectly with income taxes
 - Directly with property taxes and utility charges
- Outlines how much is owed and the penalties and interest for late payment

Collection

- Levying a tax creates a receivable for a local government
- The goal is collect 100\% of receivables; however, that isn't always possible
- Collection should never (strong words, Bland) exceed 5% of the revenue collected
- Shared responsibility is often the key to keeping costs down

Enforcement

- Effectively enforcing tax laws conveys a government's commitment to fairness and uniformity in the application of the law
- Tax liens offer a powerful tool
- Amnesty programs

Tools for Crafting a Revenue Policy

Crafting Revenue Policy

- Develop a strategic plan
- Avoid tax favors
- Pursue tax diversification
- Increase the usage of service charges
- Limit nuisance taxes
- Promote revenue self-sufficiency

Crafting Revenue Policy

- Establish a formal revenue policy
 - Helps to outline the assumptions made
 - Helps to provide continuity in services when transitions happen
 - Saves time for elected officials and executives (only have to fight battles once)