

Lecture 09

March 2019

Economics II



LISBON
SCHOOL OF
ECONOMICS &
MANAGEMENT

UNIVERSIDADE DE LISBOA

Summary

5. Government and Public Finance

5.1. Government budget: concepts and roles

5.2. Government budget: expenditures and receipts

Bibliography:

Frank and Bernanke, Chapter 11

Amaral et al. (2007), cap. 3

- Economia II – Estes materiais não são parte integrante da bibliografia da unidade curricular.

Objetives of the lecture:

- **Help you to understand the government's economic role related to the mitigation of imperfections of a market economy, including in helping promote a more efficient allocation of resources, better distribution thereof, and stabilizing the business cycle.**
- **Help you to understand the basic structure of the public sector budget, i.e., the main expenditure and revenue categories of government accounts**

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5. The Government and Public Finances

5.1. Functions of the Government

- **Regulator:** Regulation is the legal intervention in markets to alter the way in which firms and consumers behave. It does that by setting “the rules of the road, writes laws and enforces contracts and property rights. Regulates competition and merger policies; national quotas for emissions of carbon dioxide; health and safety rules”
- **Economic Agent:** acting as a producer of goods and services (e.g. education, infra-structures). To do this, it takes away resources from the private sector through taxation and injects them back in the economy through government spending.

How and to which extent should the government intervene in the economy?

→ Perennial debate in Economics and Social Sciences

- 'Liberals': government only as regulator of markets behavior
- "Non-Liberals" "Interventionists" (a larger active role of the government)
- "Keynesian" (Post Keynesian, New Keynesians)

How much should the State intervene in the economy?

Some key figures in the debate



Adam Smith, 1723-1790



John Maynard Keynes, 1883-1946



Milton Friedman, 1912-2006

This is core subject of a branch of Economics called “**Public Finance**”. It studies:

- The function, the measurement, and the management of **public expenditures** or spending (e.g. government consumption of goods and services; investment; transfers; public debt management, etc.)
- The function, the measurement, and the management of **public revenues** (e.g., taxes, social security contributions, profits from shares, etc.)
- The management of the Government or “Public Sector”
Budget

Levels of Public Administration and Definitions of State Budgets:

- **Central Government (“CG”)**: formulates the national budget
- **Local Government** (e.g. city, state or regional): in charge of “local budgets”. These can be important in countries that are more “fiscally decentralized”.
- **General Government (“GG”)** = Central + Local Governments
- **Overall or “Consolidated” Public Sector** = General Government + (non-financial) Public Enterprises

Some Important considerations:

- In order to emphasize the **separation between the functions of the fiscal and the monetary sectors**, agencies in charge of compiling countries' government finance statistics typically exclude from these different definitions of government budget (central, local, and general), any banking or monetary transactions the government performs. Thus, the accounts of the Central Bank are not included and so are the accounts of public banks.
- At each level of government, there are 3 broad groups of operations: budgetary, extra-budgetary, & social security.
- As we shall briefly discuss, the social security budget has become an increasingly large share of the GG budget.

Budget :

- Set of accounts with the revenues and expenditure plans of the government which, to be executed in modern democracies, needs authorization from parliament or congress

General Government Budget (*Sector Público Administrativo*)
= Central Administration budget + Social Security budget +
Local Government Budget

- Typically a budget estimates revenues and expenditures for the current year as well as for a few years ahead.
- In the case of Portugal, once the budget for a given year is approved by parliament, it becomes the Budget Law and is published in the Official Gazette (“diario da republica”).

Standard Presentation of Fiscal Accounts

Revenue and Grants

Tax Revenue

Turnover tax / Value-added tax

Excise taxes

Income taxes

 Corporate income taxes

 Personal income taxes

Social security/pension taxes

Foreign trade taxes

Other tax revenue

Nontax Revenue

Licenses, fees, etc.

Central bank profit transfers

Grants

Expenditure and Net Lending

Current Expenditure

Wages

Goods and services

Interest payments

 External interest payments

 Domestic interest payments

Pensions

Transfers

Subsidies

Other expenditures

Capital Expenditure

Net Lending

New policy loans (e.g., subsidized credits to farmers or public enterprises)

Repayments

Overall Balance = (Revenue and Grants) – (Expenditure and Net Lending)

Public Revenues:

- Main Breakdown in the Table: Taxes (typically main source of revenue) vs. Non-tax revenues
- **Social security contributions**
Key funding for the payment of pensions, particularly in countries where the pension system is entirely or mainly public
- **Excise Taxes**: taxes levied on specific products like tobacco, gasoline, etc.
- **Foreign trade taxes**: Taxes on imported goods and services (mainly) but also sometimes on exported goods. Important in the past, less so today.

It is also common to classify taxes in terms of:

- **Its redistributive role**

- Progressive (the average tax rate increases with the income of the tax payer).
- Regressive (the average tax rate decreases with the income of the tax payer).
- Neutral (the average tax rate is the same regardless the income of the tax payer, i.e., there is only one tax rate for the richer and the poorer).

- **Its type of base:**

- **Direct:** Levied on income or assets (patrimony)

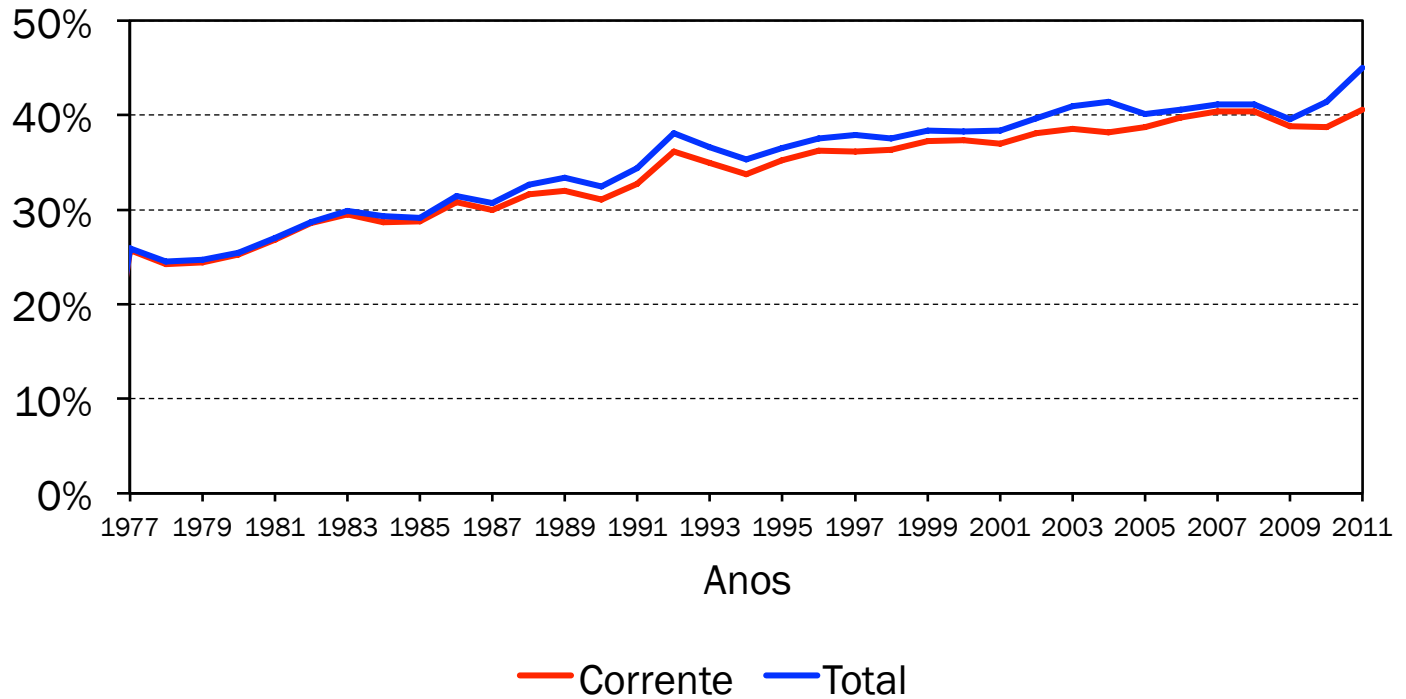
In Portugal : *IRS (Imposto sobre o Rendimento de Pessoas Singulares)* and *IRC (Imposto sobre o Rendimento de Pessoas Colectivas)* are direct taxes

- **Indirect:** Levied on goods and services transacted in the market
 - E.g. VAT

Its type of base:

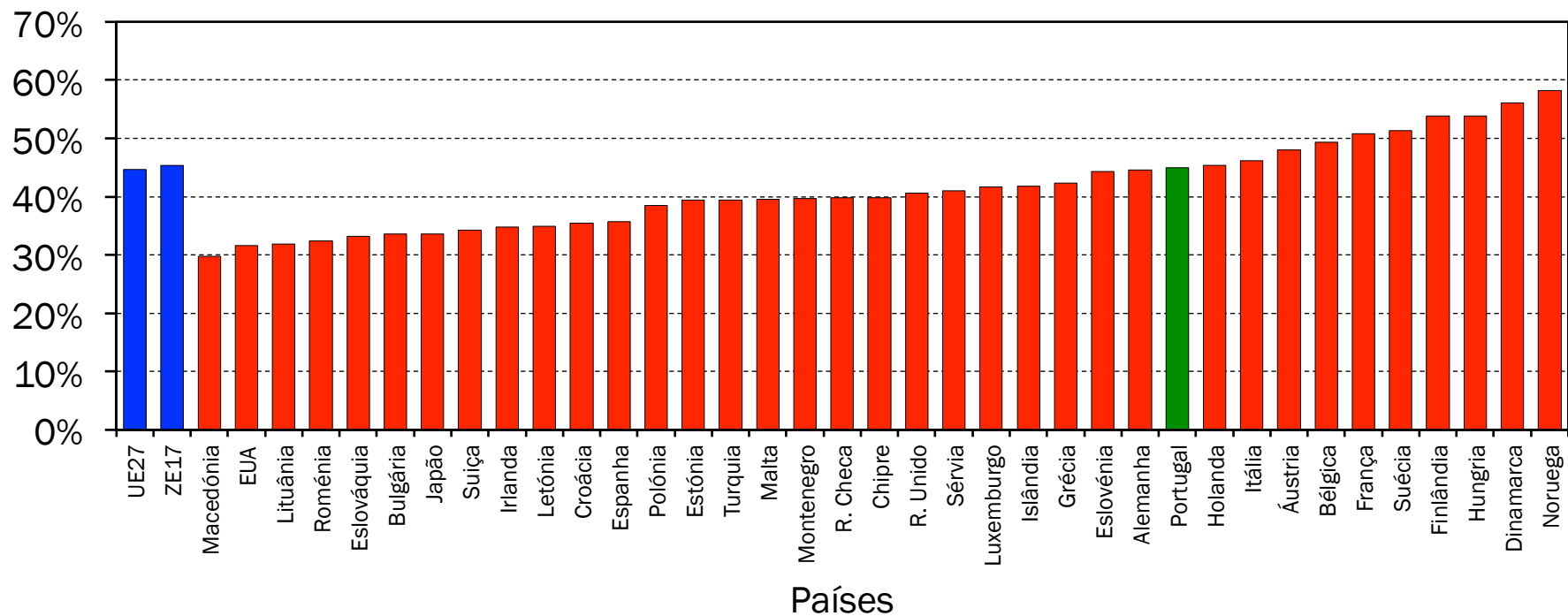
- **Whether Current vs. Capital** (i.e., revenues whose source is holding an asset expected to yield multi-year revenues). Most revenues are current revenues. Capital revenues are generally much less significant

General Government Revenue as a share of GDP in Portugal (current prices): 1977-2011



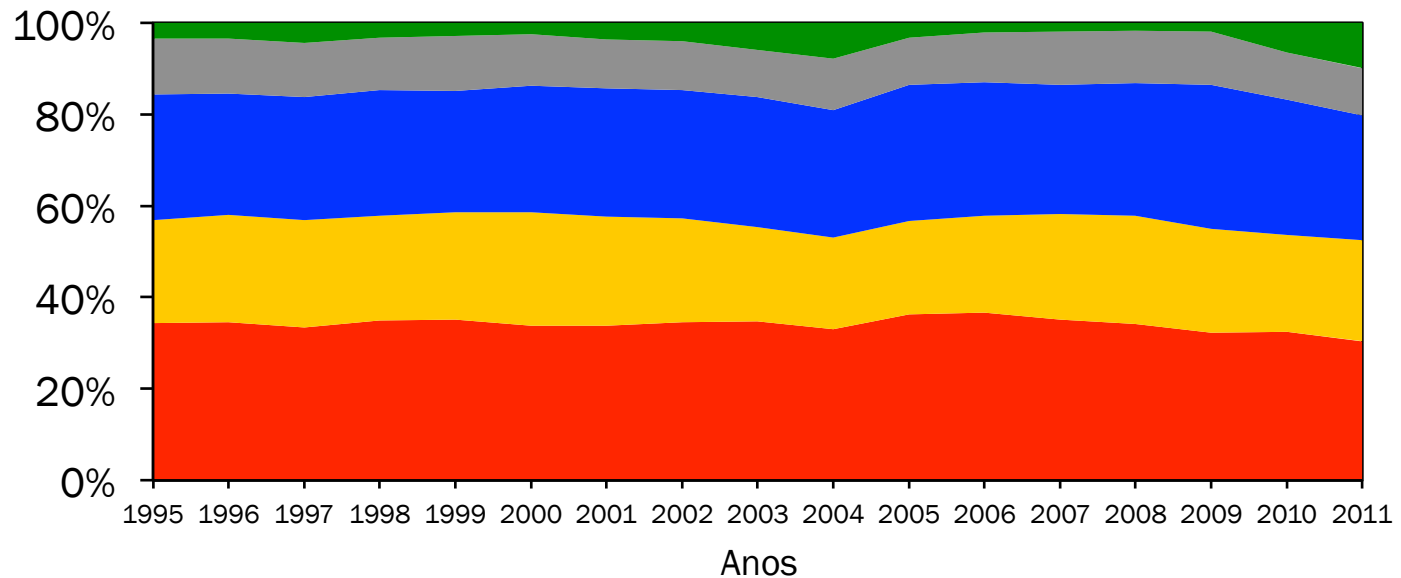
Source: [European Commission \(2012\)](#).

Public Revenues as share of GDP (current prices) for the year 2011



Fonte: [European Commission \(2012\)](#).

Structure of General Government Revenues in Portugal (current prices): 1995-2011



■ Impostos sobre a produção e importação
■ Contribuições sociais
■ Receitas de capital

■ Impostos sobre o rendimento e património
■ Outras receitas correntes

Source: [European Commission \(2012\)](#).

5.2. Public Expenditure

Main breakdown: Current vs. Capital

- **Current Expenditures:**

Budget for a year, i.e., to end in the same year:

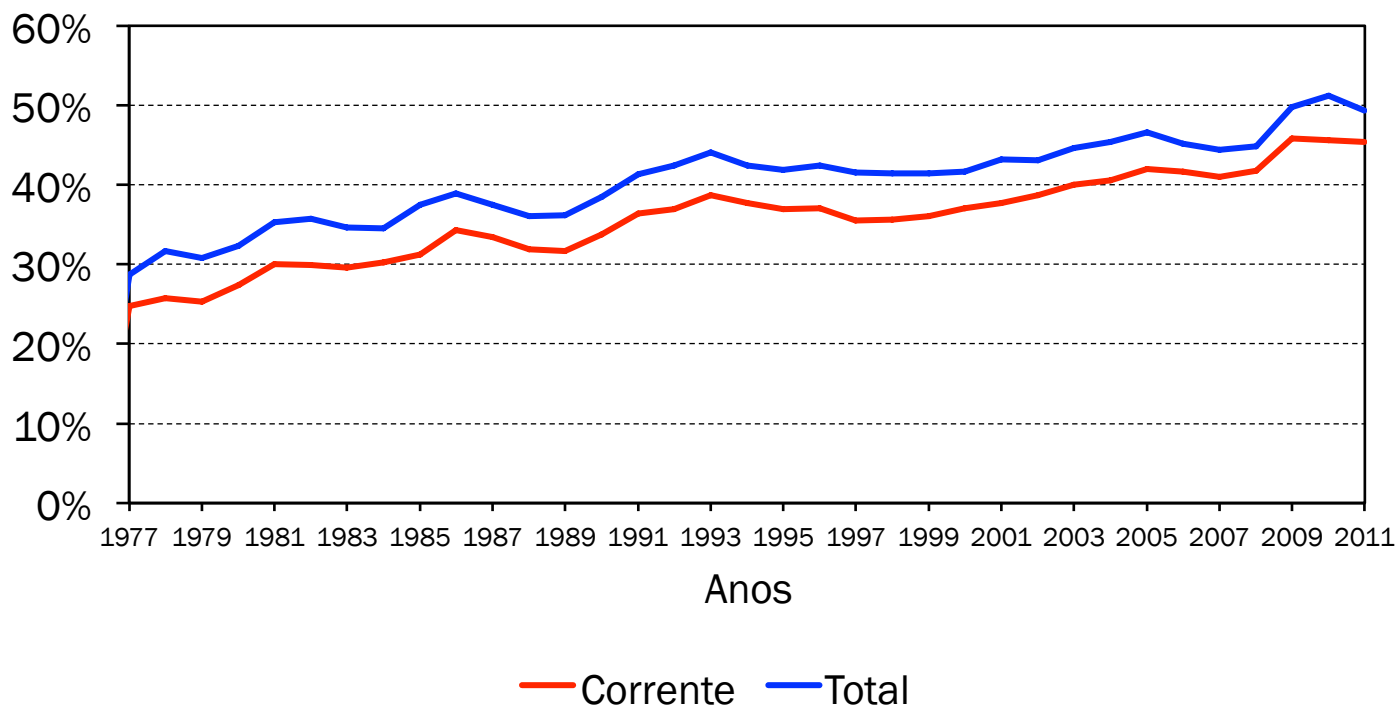
- Wages of the public sector employees;
- Purchase of goods and services (“G” in national income accounting);
- Current transfers (e.g. to households, producers);
- Payment of interest on the public debt

- **Capital Expenditures:**

- Acquisition or build-up of assets by the government which are expected to generate spending commitments over more than one year

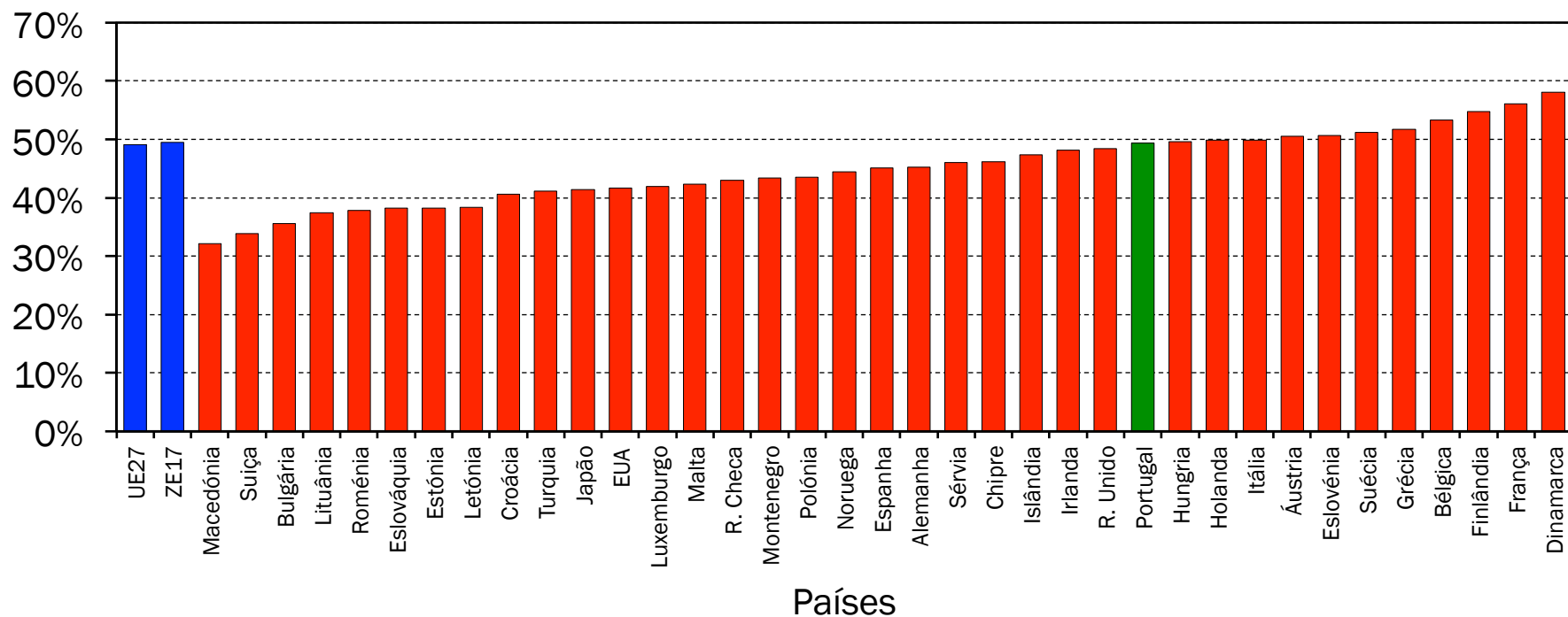
E.g. Constructin of a public hospital or a school

General Government Expenditure as a share of GDP in Portugal (current prices): 1977-2011



Source: [European Commission \(2012\)](#).

General Government Expenditure as a share of GDP in current prices in various countries in the year of 2011

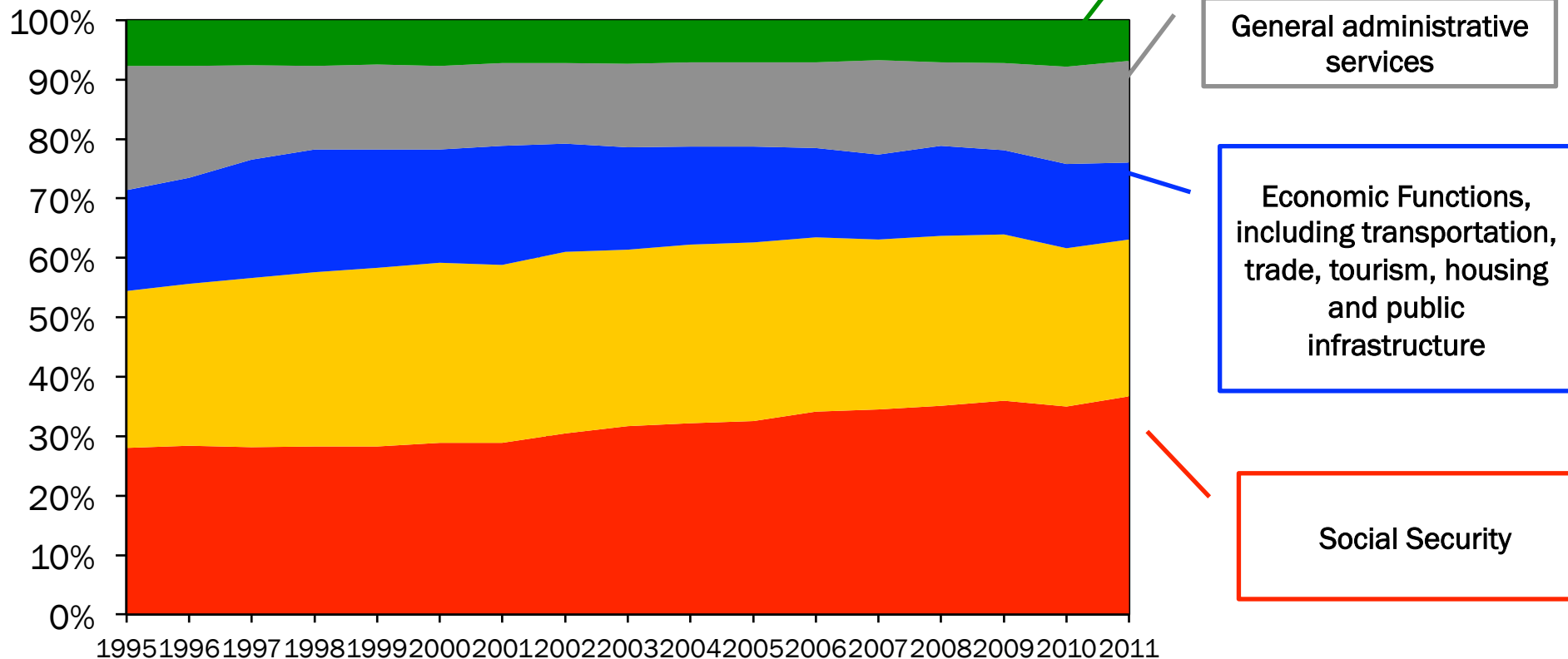


Source: [European Commission \(2012\)](#).

Functional breakdown of expenditure:

- General Functions of Sovereignty like Defense and Security
- Social Functions like Education, Social Security, Cultural Services, etc.
- Economic Functions like Industry, Transport, Trade, and Tourism Infrastructure
- General administrative services (e. g. collection and dissemination of public data, management of public debt)

Functional Structure of Public Expenditure (current prices): 1995-2011



Fonte: [INE \(2012\)](#).