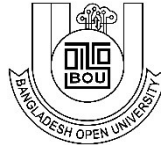


**BBA 6329**  
**Taxation and Public Finance**  
**Study Module**

**স্কুল অব বিজনেস**  
**SCHOOL OF BUSINESS**



**বাংলাদেশ উন্মুক্ত বিশ্ববিদ্যালয়**  
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**BBA 6329**  
**Taxation and Public Finance**

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# **BBA 6329**

## **Taxation and Public Finance**

### **Study Module**

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## **Preface**

This self-learning material entitled Taxation and Public Finance is designed and developed for the students of the BBA Program of the School of Business, Bangladesh Open University. It is written in modular form for easy of understanding of different theories and techniques of Taxation and Public Finance for our BBA Program.

This SLM comprises 8 units and a total of 16 lessons, carefully structured to guide learners through foundational to advanced topics. The content includes core concepts of income taxation, tax administration in Bangladesh, fiscal policy, government budgeting, public expenditure, and the broader framework of public finance. Each lesson has been crafted with a learner-centered approach to support the academic journey of our students, especially those from disadvantaged or remote areas who rely heavily on distance education resources.

This material is entirely written by me, drawing on my academic experience and practical insights. While standard references have been consulted to ensure accuracy and depth, the writing, interpretation, and organization of the content are my original contributions. It is not a replacement for comprehensive textbooks, but rather a supplementary guide to help students grasp complex topics more clearly and confidently.

I express my sincere gratitude to Professor Dr. A. B. M. Obaidul Islam, Honourable Vice Chancellor of Bangladesh Open University, for his constant encouragement and support in the preparation of this material. I am also thankful to Dr. Md. Serazul Islam, Professor, School of Business, for reviewing the module and offering thoughtful suggestions to enhance the quality of this learning resource.

It is my hope that this material will serve as a valuable academic aid for all self-learners enrolled in the BBA program. If this material empowers even a few learners to engage more deeply with the subject and apply their knowledge in practical contexts, I will consider my efforts truly meaningful and fulfilling.

**Shahima Jabin**  
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# **Tax Theory and the Nature of Tax Systems**

**1**

## **Unit Highlights**

- The functions of taxation; Tax bases;
- Tax structures - progressive, regressive, and proportional taxes;
- Hypothecation or earmarking; Tax avoidance versus tax evasion;
- Implications for public sector organization funding; and Comparisons of key systems of taxation in different countries.

## **Technologies Used for Content Delivery**

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## Lesson- 1: Taxation Systems and Structures

### Lesson Objectives

After completing the lesson, you will be able to:

- understand the primary functions of taxation and the differences between direct and indirect taxes.
- analyze the various tax bases and structures, including progressive, regressive, and proportional tax systems.

### Functions of Taxation

Taxation serves several critical functions. They are given beloww:

**Revenue Generation:** Taxation is the primary method through which a government finances its activities. The money collected through taxes enables the state to provide essential public goods and services such as national defense, education, healthcare, public infrastructure, law enforcement, and social welfare. It ensures the day-to-day functioning of government institutions and supports long-term developmental goals. Without adequate tax revenue, governments would struggle to maintain economic and social stability.

**Redistribution of Income:** Taxes play a crucial role in reducing the gap between the rich and the poor. By imposing higher tax rates on individuals and corporations with greater earnings, governments collect more from those who can afford to pay more. The funds collected are then used to provide welfare programs, social assistance, healthcare, and subsidies for the underprivileged, ensuring a more balanced and fair distribution of wealth in society. This redistribution helps reduce poverty and promotes social equity.

**Economic Stability:** Taxation is an important tool for managing economic fluctuations. During periods of inflation, higher taxes can be used to reduce excess spending power, thereby cooling the economy. Conversely, during recessions, tax reductions can increase disposable income, stimulate demand, and encourage investment, helping the economy to recover. In this way, tax policy contributes to the stabilization of the national economy by regulating demand and controlling inflation or deflation.

**Resource Allocation:** Governments use taxes to influence how resources are utilized in the economy. By increasing taxes on certain products or industries, like tobacco or fossil fuels, governments can discourage overconsumption or environmental harm. At the same time, tax incentives or deductions can encourage investment in sectors that align with national priorities, such as renewable energy, education, or technology. This steering of economic activity helps align private decisions with public interests and ensures efficient use of limited resources.

**Behavioral Influence:** Taxation can be used as a tool to shape individual and corporate behavior. By imposing taxes on harmful goods like alcohol, tobacco, or sugary drinks, governments aim to reduce consumption and promote healthier lifestyles. Similarly, carbon taxes are introduced to limit pollution and combat climate change. On the positive side, tax benefits are offered for environmentally friendly actions, donations to charity, or investments in sustainable businesses. This function demonstrates how taxation goes beyond economic considerations and can guide society toward broader social and ethical goals.

## **Direct and Indirect Taxes**

### **Direct Taxes**

Direct taxes are levied directly on individuals, corporations, or entities, based on their income, profits, or wealth. These tax is paid by the same entity that bears the economic burden, meaning the responsibility cannot be shifted to another party. Among the most significant forms of direct taxes, income tax, which is calculated on the earnings of individuals and businesses. For individuals, income tax is typically progressive, meaning that higher income levels are taxed at higher rates. This system is designed to promote equity by ensuring that those who earn more contribute a larger share of their income to public funds. For corporations, corporate tax applies to net profits after deducting expenses. This tax affects business decisions on investment, reinvestment, and dividend distribution, and is also a critical source of revenue for governments, especially in developed economies.

Another example is the wealth tax, which is imposed on the net wealth of an individual. This includes assets such as property, bank deposits, shares, bonds, and other forms of capital. Though not widely used today due to administrative complexity and potential capital flight, wealth taxes are occasionally discussed as tools for addressing wealth inequality and funding expansive social programs. Some countries, like Spain and Norway, still maintain forms of wealth taxation.

Other examples of direct taxes include capital gains tax, which is applied to the profit from the sale of assets like real estate and stocks, and property tax, which is levied on the ownership of land or buildings. These taxes help fund local governments, schools, and municipal services.

### **Indirect Taxes**

Indirect taxes are levied on the consumption of goods and services rather than on income or wealth. The tax is initially paid by businesses, but the burden is passed on to consumers in the form of higher prices. This makes indirect taxes regressive in nature, as lower-income households tend to spend a larger proportion of their income on taxed goods and services.

A common type of indirect tax is the sales tax, which is imposed at the point of sale for goods and services. The consumer pays this tax as part of the final purchase price, and the seller remits it to the government. A more modern and comprehensive form is the value-added tax (VAT), which is collected at each stage of the production and distribution chain based on the value added at that stage. VAT systems are widely used globally due to their transparency, revenue-generating efficiency, and resistance to tax evasion compared to traditional sales taxes.

Excise duties are another form of indirect tax, targeting specific goods that are often considered harmful or luxury items. Common examples include taxes on alcohol, tobacco, sugary beverages, and fuel. These taxes serve both fiscal and behavioral objectives. They generate substantial revenue, especially in countries with large consumption bases, and also discourage the use of harmful products. For instance, high excise duties on cigarettes are part of broader public health strategies to reduce smoking rates.

Additionally, indirect taxes can include customs duties, which are taxes on imports and exports. These serve multiple functions: protecting domestic industries, regulating trade balances, and generating revenue from international commerce.

While direct taxes are often perceived as fairer due to their progressive nature, they can be harder to administer and are more susceptible to evasion through tax loopholes or avoidance strategies. Indirect taxes, on the other hand, are relatively easier to collect and enforce but may

disproportionately affect lower-income groups unless offset by subsidies or exemptions for essential goods.

## **Tax Bases**

**Income:** Income tax is charged on wages, salaries, dividends, and other income forms. This is often a direct tax.

**Consumption:** Taxes on consumption, such as sales tax or VAT, are levied on the purchase of goods and services. These are generally indirect taxes.

**Wealth:** Wealth taxes are imposed on ownership of assets like property, land, and stocks.

**Capital Gains:** A tax on the profit made from selling an asset (such as real estate or stocks) at a higher price than its purchase cost.

## **Tax Structure: Progressive, Regressive, and Proportional Taxes**

Tax structures determine how the tax burden is distributed across different income levels. The fairness, efficiency, and economic effects of a tax system often depend on which structure is in place. The three primary types are progressive, regressive, and proportional taxes.

### **Progressive Tax**

A progressive tax system imposes a higher tax rate on individuals or entities as their income increases. The core idea is that those who have a greater ability to pay should contribute a larger share of their income to public revenue. This system is widely seen as equitable because it reduces the relative tax burden on low-income earners while taxing the wealthy more heavily.

In practice, progressive taxes are often implemented using tax brackets. For instance, someone earning \$20,000 might pay 10% in taxes, while someone earning \$200,000 could pay 30%. Only the income that falls within each bracket is taxed at that bracket's rate, making the marginal tax rate a key concept in progressive taxation.

Progressive taxes play an essential role in reducing income inequality. The additional revenue from high-income earners often funds social programs like public education, healthcare, housing, and income support for lower-income citizens. Countries like the United States, Canada, the UK, and many EU nations employ progressive income tax systems.

Critics, however, argue that if rates become too high, it may discourage investment, entrepreneurship, or high-income productivity. Still, when well-calibrated, progressive taxation is considered a cornerstone of social justice and economic fairness.

### **Regressive Tax:**

A regressive tax system is one in which the effective tax rate decreases as income increases. In other words, low-income individuals pay a greater percentage of their income in taxes than high-income individuals. This structure often arises unintentionally through indirect taxes, such as sales tax or consumption taxes, which are applied uniformly to all purchases regardless of the buyer's income.

For example, if a \$1,000 monthly grocery bill includes a 10% sales tax, that \$100 in tax represents 10% of income for someone earning \$1,000/month, but only 1% for someone earning \$10,000/month. This results in a heavier relative burden on those with less disposable income.

Excise taxes on goods such as gasoline, alcohol, and tobacco are also considered regressive. While intended to change consumer behavior or raise revenue, they disproportionately affect lower-income individuals who spend more of their earnings on such essentials or affected goods.

Critics of regressive taxation highlight its potential to exacerbate poverty and inequality. However, proponents argue that consumption-based taxes are simpler to administer and harder to evade than income taxes. Governments can also offset the regressive impact by exempting essential goods from tax or providing targeted subsidies to low-income households.

### **Proportional Tax:**

A proportional tax system, commonly known as a flat tax, charges the same percentage of income from all taxpayers, regardless of how much they earn. For instance, whether an individual earns \$30,000 or \$300,000, they would both pay, say, 20% in income tax under a flat tax regime.

Supporters of proportional taxes argue that it is a simpler and more transparent system. It eliminates the complexity of tax brackets and loopholes, which often lead to tax avoidance. They also suggest it promotes economic efficiency by not penalizing higher earnings or discouraging productivity.

However, critics point out that while the tax rate is the same, the impact is not. Paying 20% of a low income can be far more burdensome than paying 20% of a high income, particularly when considering basic living costs. In this sense, flat taxes can be seen as regressive in effect, even though they are technically proportional in rate.

Some countries, particularly in Eastern Europe—like Estonia, Latvia, and Russia—have implemented flat tax systems to simplify administration and boost compliance. In many cases, these systems have been paired with exemptions or deductions for low-income earners to mitigate the regressive impact.

Each tax structure has its strengths and trade-offs. Progressive taxes promote equity and social welfare but may be more complex to administer. Regressive taxes, while simple and efficient, risk widening economic inequality if not balanced with social policies. Proportional taxes offer clarity and uniformity but may need adjustments to ensure fairness for lower-income groups. A well-designed tax system often incorporates elements of all three structures to balance efficiency, equity, and simplicity, ensuring sustainable revenue generation while fostering economic and social development.

## Lesson- 2: Concepts of Taxation and Tax System across Different Countries

### Lesson Objectives

After completing the lesson, you will be able to:

- understand the concepts of hypothecation, tax avoidance, and tax evasion, and their implications for public sector funding.
- compare tax systems across different countries and assess their impact on economic policy and public finance.

### Hypothecation or Earmarking

Hypothecation, also known as earmarking, refers to the practice of allocating specific tax revenues for particular government expenditures. Instead of pooling all collected taxes into a general fund for distribution across various sectors, hypothecated taxes are dedicated to a specific purpose or project. This method is often used to build public trust and justify taxation by directly linking tax contributions to visible public benefits.

When a government imposes a tax and promises that the revenue collected will be used for a defined purpose, it is engaging in hypothecation. A common example is a fuel tax that is earmarked for maintaining and developing roads, highways, or public transportation infrastructure. Similarly, tobacco taxes may be earmarked to fund public health campaigns or healthcare services related to smoking-related illnesses.

### Types of Hypothecation

- **Soft Hypothecation:** The tax revenue is intended for a specific purpose, but the government retains flexibility to reallocate funds if necessary. This is more of a policy guideline than a legal obligation.
- **Hard Hypothecation:** The use of the revenue is legally binding and strictly limited to the earmarked purpose. This can be embedded in legislation or constitutional rules.

### Advantages of Hypothecation

**Transparency and Accountability:** Citizens can see exactly where their tax money is going, which may increase public support for certain taxes, especially those seen as burdensome.

**Trust in Public Finance:** Linking taxes to tangible outcomes (e.g., road improvements funded by vehicle taxes) can enhance taxpayer trust in government.

**Improved Budget Planning:** Departments benefiting from earmarked funds can plan long-term projects with greater financial certainty.

**Policy Alignment:** Hypothecation can align revenue generation with expenditure priorities (e.g., environmental taxes funding renewable energy projects).

### Disadvantages of Hypothecation

**Reduced Budget Flexibility:** By locking funds into specific uses, governments may struggle to respond to changing needs or emergencies in other sectors.

**Funding Mismatches:** The amount of tax collected may not align with actual expenditure needs. For example, a high fuel tax during economic booms might generate more revenue

than needed for roads, while in recessions, revenue may fall short of infrastructure demands.

**Inefficiency Risks:** Earmarked funds might continue to flow into a sector even when it's no longer a priority, potentially leading to inefficiencies or overfunding.

**Political Manipulation:** Governments might use hypothecation as a tool to gain public support for otherwise unpopular taxes, without necessarily following through effectively on the promised expenditures.

## Real-World Examples

**United States:** The federal gasoline tax is earmarked for the Highway Trust Fund, which finances road and bridge construction and maintenance.

**United Kingdom:** There have been discussions and partial applications of hypothecation for taxes like the vehicle excise duty to fund road projects.

**India:** The health and education cess collected through income tax is earmarked for health and education sector spending.

**Bangladesh:** While generally less formalized, earmarking exists in sectors like infrastructure, where development surcharges or tolls are meant to support specific projects.

Hypothecation can be a powerful tool for building public trust, aligning taxation with public priorities, and improving fiscal transparency. However, it must be used carefully to avoid undermining the broader flexibility and efficiency of national budgeting systems. A balanced approach—where critical services are guaranteed stable funding but governments retain the ability to reallocate resources as needed—is often the most effective strategy.

## Tax Avoidance vs. Tax Evasion

Both tax avoidance and tax evasion involve reducing tax liabilities, but they differ fundamentally in legality, intent, and ethical considerations.

### Tax Avoidance

Tax avoidance refers to the use of legal strategies, methods, or loopholes within the law to reduce the amount of tax an individual or business owes. It involves meticulous tax planning and taking advantage of deductions, exemptions, and incentives allowed by tax authorities.

### Key Characteristics:

**Legal:** It operates within the boundaries of the law.

**Planned:** Often guided by tax consultants or financial advisors.

**Common Tools:** Income shifting, using tax shelters, investing in tax-exempt securities, or establishing entities in low-tax jurisdictions.

### Examples:

- Claiming deductions for business expenses or charitable donations.
- Structuring investments to benefit from capital gains tax rates rather than higher income tax rates.
- Utilizing retirement accounts or offshore trusts legally.

### **Ethical Concerns:**

While legal, aggressive tax avoidance can be ethically questionable, particularly when it exploits loopholes to minimize taxes significantly. Large multinational corporations (e.g., Apple, Google, Amazon) have faced public criticism for using complex international structures to shift profits to low-tax jurisdictions, even though technically legal.

### **Impact:**

- Reduces government tax revenue.
- Can erode public trust in the fairness of the tax system.
- Often prompts calls for tax reforms to close legal loopholes.

### **Tax Evasion**

Tax evasion is the illegal practice of intentionally concealing income, inflating expenses, or otherwise misrepresenting financial information to reduce tax liability.

### **Key Characteristics:**

**Illegal and punishable:** Tax evasion is a criminal offense in most jurisdictions.

**Deliberate deception:** It involves fraud, misreporting, or hiding financial data.

**Investigated and prosecuted:** Revenue authorities such as the IRS (U.S.) or NBR (Bangladesh) actively pursue evaders.

### **Examples:**

- Failing to report cash income.
- Claiming fake business expenses or personal costs as business deductions.
- Hiding money in secret offshore accounts or tax havens.
- Not filing tax returns despite earning taxable income.

### **Legal Consequences:**

- Heavy fines and penalties.
- Interest on unpaid taxes.
- Criminal prosecution, which can lead to imprisonment.
- Seizure of assets or business closure in severe cases.

### **Impact:**

- Severely undermines public finances and the delivery of essential services.
- Distorts fair competition (non-compliant businesses gain unfair advantage).
- Encourages corruption and weakens governance.

### **Implications for Public Sector Funding**

#### **Direct Taxes:**

Provide a steady source of revenue for governments and are typically more predictable, allowing for better long-term public sector budgeting.

**Indirect Taxes:**

Can be regressive and impact low income households disproportionately, but are easier to administer and can be used to adjust consumer behavior.

**Tax Evasion and Avoidance:**

Significant challenges for public sector funding as they lead to a loss of revenue, impacting the government's ability to fund services effectively.

**Comparison of Key Tax Systems in Different Countries****United States:**

The United States operates a progressive federal income tax system, where tax rates increase with income, reaching a top marginal rate of around 37%. In addition to federal taxes, most states impose their own income taxes, though some states like Florida and Texas do not. The U.S. does not have a national value-added tax (VAT); instead, sales taxes are determined at the state and local levels, ranging widely between jurisdictions. Since the 2017 Tax Cuts and Jobs Act, the federal corporate tax rate has been lowered to 21% to stimulate business investment. The U.S. also taxes its citizens on their worldwide income, making its tax system globally oriented.

**United Kingdom:**

The United Kingdom features a progressive income tax system with three main bands: 20% (basic), 40% (higher), and 45% (additional), along with mandatory National Insurance contributions. Corporate tax is set at 25% for large companies, with a lower rate for smaller firms. A major source of government revenue comes from the Value Added Tax (VAT), set at 20%, with reduced or zero rates on essential goods and services. The UK also employs hypothecation in some areas, such as the sugar tax, which is earmarked for health initiatives.

**Germany:**

In Germany, the tax system is also progressive, with income tax rates reaching up to 45% for top earners, and an additional “solidarity surcharge” applied on high incomes to support economic development in former East Germany. Germany has one of the highest social security contributions in Europe, funding a comprehensive welfare system. The standard VAT rate is 19%, with a reduced rate of 7% for necessities such as food and books. Corporate tax rates combine a federal rate of 15% and local trade taxes, bringing the effective rate to around 30%.

**Singapore:**

Singapore, in contrast, follows a more proportional approach to taxation. It imposes low income tax rates, with a maximum of 22% for individuals, and corporate tax is capped at 17%. There is no capital gains tax, and dividend income is also tax-free. Singapore relies on a broad-based consumption tax known as the Goods and Services Tax (GST), currently set at 9% as of 2024. The country’s tax system is designed to be investment-friendly, with numerous incentives and tax relief schemes aimed at attracting foreign business and supporting innovation.

Each country’s tax system reflects its economic philosophy and public policy priorities—ranging from the redistributive goals of the UK and Germany to the investment-driven, low-tax strategy of Singapore.



## Relevant Questions

1. What are the main functions of taxation, and how do they contribute to public finance and economic stability?
2. How does taxation help redistribute wealth and reduce income inequality?
3. What are the differences between direct and indirect taxes, and how does each affect taxpayers differently?
4. Why might governments rely more on indirect taxes, even though they can be regressive?
5. What are the key tax bases (income, consumption, wealth), and how does the government choose which base to tax more heavily?
6. How do consumption taxes, like VAT, affect different income groups?
7. What are the differences between progressive, regressive, and proportional tax systems, and how do they impact income distribution?
8. Why might a country choose a flat (proportional) tax system over a progressive one?
9. What are the advantages and disadvantages of hypothecation in government budgeting and tax allocation?
10. What are the legal differences between tax avoidance and tax evasion, and how do they affect government revenues?
11. How can governments address aggressive tax avoidance practices without discouraging investment?
12. How do tax avoidance and evasion impact the ability of public sector organizations to fund essential services?
13. How do the tax systems of the United States, United Kingdom, and Singapore differ in their approach to taxation, and what impact do these differences have on their economies?

## Reference:

Shil, N. C. (2023). *Bangladesh income tax: Theory and practice* (12th ed.). CSM Foundation.



### Unit Highlights

- Characteristics of Income Tax; Objectives and importance of Income Tax;
- Role and scheme of Income Tax law; Structure of Income Tax Ordinance, 1984;
- Income tax payment procedure in Bangladesh; Rights and obligation of a taxpayer under the ITO, 1984;
- Relevant statutory definitions and important concepts relating tax.

### Technologies Used for Content Delivery

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## **Lesson- 1: Characteristics and Provisions related to Income Tax**

### **Lesson Objectives**

After completing the lesson, you will be able to:

- identify the key characteristics, objectives, and importance of income tax in Bangladesh.
- explain the role of income tax laws and the overall scheme of the Income Tax Ordinance (ITO) 1984.
- Describe the structure and provisions of the Income Tax Ordinance 1984

### **Characteristics of Bangladesh Income Tax**

Income tax in Bangladesh is a direct tax levied on the income of individuals, companies, and other entities. Key characteristics include:

**Progressive Nature:** Income tax in Bangladesh follows a progressive tax rate system, meaning that individuals with higher incomes are taxed at higher rates.

**Direct Tax:** Income tax is a form of direct taxation, where the burden of payment falls directly on the taxpayer, unlike indirect taxes (e.g., VAT).

**Annual Obligation:** Taxpayers must file their income tax returns on an annual basis, declaring income earned during the previous fiscal year.

**Legal Requirement:** Payment of income tax is mandatory under the Income Tax Ordinance, 1984, and is enforced by the National Board of Revenue (NBR).

**Sources of Income:** Income tax is levied on income derived from various sources, such as salaries, business profits, property, and capital gains.

### **Objectives of the Income Tax**

**Revenue Generation:** The primary objective of income tax is to generate revenue for the government. This revenue is crucial for funding a wide range of public services, including healthcare, education, infrastructure development, national security, and welfare programs. Governments depend on income tax as a reliable source of income to meet budgetary requirements and ensure that public services remain operational and accessible to citizens. The revenue from income tax is also essential for maintaining the stability of the national economy by enabling the government to meet its financial obligations.

**Redistribution of Wealth:** Income tax serves the important social function of reducing wealth inequality within a country. By imposing higher tax rates on individuals with higher incomes, the system aims to redistribute wealth from the wealthy to the less affluent. This redistribution often occurs through social programs funded by the revenue generated from income tax. These programs can include welfare benefits, unemployment insurance, public health services, and subsidies for education and housing, all of which are designed to improve the living standards of lower-income citizens. The redistribution process helps to foster social equity and reduce income disparities that may otherwise lead to social unrest or division.

**Economic Stability:** Income tax is a tool used by governments to influence the broader economy and maintain macroeconomic stability. During times of economic growth and high inflation, governments may increase income tax rates or limit certain deductions and exemptions to slow down excessive consumption and curb inflationary pressures. Conversely, in periods of economic downturn or recession, tax rates may be reduced, or exemptions may be expanded to encourage spending and investment, thereby stimulating economic recovery. By adjusting tax policy, governments can help smooth out economic cycles and stabilize the economy, ensuring sustainable growth and preventing extreme fluctuations.

**Encouraging Compliance:** Another key objective of income tax policy is to ensure taxpayer compliance and reduce tax evasion. Governments design tax systems with incentives such as tax credits, deductions, and exemptions to encourage individuals and businesses to report their income honestly and fully. Simplified filing procedures and clear guidelines also play a role in making it easier for taxpayers to comply with the system. By fostering a culture of compliance and making the process as straightforward as possible, governments can enhance the efficiency of tax collection, minimize the costs associated with tax enforcement, and ensure that all eligible taxpayers contribute their fair share to the national revenue.

In summary, income tax serves multiple vital functions: generating government revenue, promoting wealth redistribution, maintaining economic stability, and encouraging compliance. Each of these objectives plays a crucial role in ensuring that the tax system supports both the financial health of the government and the social and economic well-being of citizens.

### **Importance of the Income Tax**

**Funding Public Services:** Income tax is the backbone of government revenue, enabling the funding of essential public services that are crucial for the well-being of society. These services include education, which is vital for developing human capital, healthcare, which ensures the physical well-being of the population, defense, which protects national security, and infrastructure development, which supports the functioning of the economy. Without sufficient income tax revenue, the government would struggle to finance these public goods and services, leading to a decrease in the quality of life for citizens and possibly hindering economic growth.

**Economic Development:** In developing countries like Bangladesh, income tax revenue plays an especially significant role in financing the country's economic and social development. The funds raised through income tax contribute to key development initiatives, such as improving infrastructure (e.g., roads, bridges, and public transportation), enhancing education and healthcare systems, and supporting poverty reduction programs. This revenue is essential for fostering sustainable economic growth and addressing development challenges. For countries with limited external aid or investment, a robust income tax system is necessary to build a self-sustaining economy.

**Social Justice:** A well-structured and progressive income tax system is an important tool for ensuring social justice. By taxing individuals and corporations based on their income and wealth, the system redistributes resources to reduce inequality and create a more equitable society. Higher earners are taxed at higher rates, while lower-income groups benefit from social programs funded by this revenue. This redistribution helps level the playing field, providing equal opportunities for all citizens, regardless of their socioeconomic background. By addressing wealth disparities, income tax helps mitigate social unrest and promotes a more cohesive society.

Overall, income tax is not only a mechanism for raising government funds but also a critical instrument for fostering social equity, financing development, and ensuring the well-being of the population.

### **Role and Scheme of Income Tax Law in Bangladesh**

The **Income Tax Ordinance (ITO) 1984** serves as the foundational legal framework for income taxation in Bangladesh. Its role can be summarized as follows:

## **Legal Framework**

The ITO establishes the rules and regulations governing income tax in Bangladesh. It defines the authority of tax officials and the rights of taxpayers, creating a structured environment for tax administration.

## **Taxation Authority**

The ordinance empowers the National Board of Revenue (NBR) to administer and enforce tax laws, ensuring compliance among taxpayers.

## **Taxpayer Guidance**

It provides detailed guidelines for taxpayers on how to compute taxable income, the categories of income subject to taxation, and the allowable deductions and exemptions.

## **Assessment and Collection Procedures**

The ITO outlines the processes for tax assessment, including how income is to be evaluated, the methods of auditing, and the timeline for filing returns.

## **Compliance Mechanisms**

The ordinance includes provisions for audits, penalties for noncompliance, and procedures for appeals against tax assessments, ensuring accountability in the tax system.

## **Economic Regulation**

The income tax law plays a crucial role in regulating the economy by influencing investment decisions, consumer spending, and overall economic growth through tax policies.

## **Scheme of the Income Tax Ordinance 1984**

The scheme of the ITO is designed to comprehensively address various aspects of income tax. It includes several chapters, each focusing on a specific area of tax regulation:

### **Preliminary Provisions**

**Chapter I** contains definitions and introductory clauses, laying the groundwork for the ordinance.

### **Tax Authority**

**Chapter II** details the powers and responsibilities of the NBR and other tax authorities, including their roles in assessment and collection.

### **Taxable Income and Computation**

**Chapter III** discusses what constitutes taxable income, the computation methods, and the classification of income into categories (e.g., salaries, business income, capital gains).

### **Assessment Procedures**

**Chapter IV** outlines the procedures for assessing income tax, including the filing of returns, methods of assessment (self-assessment, assessment by tax authorities), and the timeline for these processes.

### **Appeals and Revisions**

**Chapter V** provides the framework for taxpayers to appeal against tax assessments, detailing the steps involved in the appeal process and the hierarchy of appeal authorities.

### **Offenses and Penalties**

**Chapter VI** specifies various offenses related to tax evasion, fraud, and noncompliance, along with the penalties applicable for such offenses.

### **Miscellaneous Provisions**

**Chapter VII** includes various provisions that do not fall into the previous categories, addressing issues like the treatment of certain income sources and other administrative matters.

### **Schedules**

The ITO contains schedules that list specific tax rates, exemptions, and deductions applicable under different circumstances, facilitating easier reference for taxpayers.

The ITO 1984 provides a comprehensive framework for income taxation in Bangladesh, ensuring transparency, fairness, and efficiency in tax administration. Its structured approach allows for effective governance of income tax laws, promoting compliance while safeguarding taxpayer rights.



## **Lesson- 2: Income Tax payment in Bangladesh**

### **Lesson Objectives**

After completing the lesson, you will be able to:

- the procedures for income tax payment in Bangladesh.
- the rights and obligations of a taxpayer under the ITO 1984.
- relevant statutory definitions and important concepts related to tax law.

### **Income Tax Payment Procedure in Bangladesh**

The procedure for income tax payment in Bangladesh involves several key steps:

**Tax Identification Number (TIN):** Every taxpayer must obtain a TIN, which is required for filing income tax returns.

**Preparation of Tax Returns:** Taxpayers need to calculate their total taxable income based on income from all sources and prepare the necessary tax returns.

**Submission of Tax Returns:** Taxpayers must submit their tax returns annually, usually by November 30th of each year, using prescribed forms (IT11GA, etc.).

**Tax Payment:** After assessment, the tax liability must be paid either in lump sum or in instalments. Payment can be made at authorized banks or through the online payment portal of the NBR.

**Assessment by Tax Authorities:** Once tax returns are submitted, the tax authorities assess the returns. If any discrepancies or errors are found, the taxpayer may be notified for reassessment.

**Appeal Process:** If a taxpayer disagrees with the assessment, they can appeal to the tax authorities, and if necessary, escalate the matter to the Appellate Tribunal or High Court.

### **Rights and Obligations of a Taxpayer under the ITO 1984**

#### **Rights of a Taxpayer:**

**Right to Information:** Taxpayers are entitled to receive information from tax authorities about their tax liabilities and the process.

**Right to Fair Assessment:** Taxpayers have the right to expect a fair and transparent assessment of their income tax returns.

**Right to Appeal:** Taxpayers have the right to appeal against any tax assessment they believe to be unjust or incorrect.

**Right to Refund:** If excess tax is paid, taxpayers have the right to claim a refund.

**Right to Legal Representation:** Taxpayers have the right to seek legal or professional assistance in filing returns or during assessments.

#### **Obligations of a Taxpayer:**

**Accurate Declaration of Income:** Taxpayers are obligated to truthfully declare all sources of income in their returns.

**Timely Payment:** Taxpayers must pay their taxes by the due date to avoid penalties.

**Maintaining Records:** Taxpayers must maintain accurate records of income, expenditures, and deductions for future reference and audits.

**Cooperation with Tax Authorities:** Taxpayers are required to cooperate with tax officials during assessments or investigations.

**Compliance with Tax Laws:** Taxpayers must comply with all provisions of the ITO and related regulations.

### **Relevant Statutory Definitions and Important Concepts**

**Income:** Under the ITO, "income" refers to earnings from various sources, including salaries, business income, property, investments, and capital gains.

**Taxable Income:** This is the income on which tax is calculated after considering deductions, allowances, and exemptions.

**Assessment Year:** The fiscal year in which the income earned in the previous year is assessed and taxed.

**Tax Deduction at Source (TDS):** This refers to the practice where tax is deducted from income at the point of earning, such as on salaries, dividends, or interest.

**Advance Tax:** Tax paid in advance by the taxpayer, based on estimated income for the year, before the final assessment.

### **Relevant Questions:**

1. What are the main characteristics of the income tax system in Bangladesh?
2. Explain the objectives and importance of income tax in a developing country like Bangladesh.
3. Describe the role of the Income Tax Ordinance, 1984, in regulating tax collection in Bangladesh.
4. Outline the structure of the Income Tax Ordinance 1984. What are the key chapters and provisions?
5. What is the procedure for paying income tax in Bangladesh?
6. What rights and obligations does a taxpayer have under the ITO 1984?
7. Define the terms "income," "taxable income," and "assessment year" as per the ITO 1984.
8. What is Tax Deduction at Source (TDS) and how does it function in the context of income tax?

### **Reference:**

- Morshed, M., & Kumar, K. (2019). *Taxation in Bangladesh: Theory and practice* (2nd ed.). Khan Brothers Publication.
- Shil, N. C. (2023). *Bangladesh income tax: Theory and practice* (12th ed.). CSM Foundation.

### Unit Highlights

- Income Structure and Taxability under Employment;
- Scope and Computation of Income;
- Corporate Taxation and Special Levies;
- Taxpayer Identification and Compliance Procedures.

### Technologies Used for Content Delivery

- ❖ BOUTUBE
- ❖ BOU LMS
- ❖ WebTV
- ❖ Web Radio
- ❖ Mobile Technology with MicroSD Card
- ❖ BTV Program
- ❖ Bangladesh Betar Program



## **Lesson- 1: Computation of total Income and tax Liability**

### **Lesson Objectives**

After completing the lesson, you will be able to:

- An in depth understanding of the income year and assessment year.
- Knowledge of how to compute total income and applicable tax rates.

### **Basics of Income Tax in Bangladesh**

#### **Income Year and Assessment Year**

**Income Year:** The income year in Bangladesh runs from **July 1 to June 30** of the following year. This is the period during which all income is earned.

**Assessment Year:** The assessment year immediately follows the income year, also from **July 1 to June 30** of the subsequent year. This is the year when taxpayers file their returns based on income earned in the previous year.

#### **Components of Salary (Section 32(2))**

The term salary is defined to encompass a broad range of income, which includes:

**Basic Salary:** The fixed amount paid to the employee for the work performed.

**Dearness Allowances:** Paid to counter inflation, dearness allowances are fully taxable.

**House Rent Allowances:** Taxable unless the employee can provide evidence that it is used for rent, in which case certain exemptions may apply.

**Bonuses and Gratuities:** Bonuses paid for performance or during special occasions (e.g., Eid, Christmas) are added to taxable income. Gratuities, depending on the amount and the nature of the fund (approved or unapproved), can be either fully or partially taxable.

**Employer Contributions:** Contributions to provident funds or superannuation funds by employers are taxed unless they fall within specified exemptions.

The **receipts in lieu of salary**, such as compensation for termination of employment, deferred salary payments, or encashment of leave, are also taxable under employment income. Any benefits received due to changes in employment contracts or future remuneration from past employment also fall under the taxable category.

#### **Valuation of Perquisites (Section 33)**

Perquisites are benefits provided to employees in forms other than cash. These include rentfree accommodation, use of company cars, and other similar benefits. For taxation purposes, these noncash benefits are valued at their monetary equivalent.

#### **Rent Free Accommodation**

If an employer provides rent free accommodation, the value of the accommodation is included in the employee's taxable income. The amount added to taxable income is the higher of:

- The fair market rent of the accommodation, or
- The actual rent paid by the employer on behalf of the employee.

If the employee pays a part of the rent, the difference between the market rent and the rent paid by the employee is added to taxable income. For example, if the fair market value of an

apartment is Tk 50,000 per month and the employee pays Tk 20,000, the remaining Tk 30,000 is considered a taxable benefit.

### **Car Benefits**

The provision of company cars is a common perquisite. For tax purposes, the valuation of car benefits depends on the engine capacity of the vehicle. If the vehicle is less than 2500cc, Tk 10,000 per month is added to the taxable income. For cars larger than 2500cc, Tk 25,000 per month is added. If the car is used both for personal and official purposes, a part of this amount may be deducted.

### **Other Perquisites**

Other common perquisites include employee provided utilities, club memberships, and telephone allowances. Each of these is added to taxable income based on its fair market value or the actual amount paid by the employer.

### **Employee Share Schemes (Section 34)**

The Employee Share Schemes is what employees are given shares in the company, either as part of their remuneration or through special share plans.

For tax purposes, the value of shares given to employees is calculated as:

$$\text{Taxable Income} = \text{Fair Market Value (FMV)} - \text{Acquisition cost.}$$

For example, if an employee is given 10,000 shares with an FMV of Tk 1,000,000, and the acquisition cost paid by the employee is Tk 100,000, the taxable amount added to the employee's income is Tk 900,000.

If the employee sells or transfers their right to acquire shares, the difference between the sale price and the acquisition cost is taxed as employment income. This section also covers the valuation of stock options and bonus shares.

### **Provident Fund (Section 4.4)**

The provident fund is a critical element of retirement planning in many employment contracts. General Provident Fund (GPF)

The General Provident Fund (GPF) is usually contributed to solely by the employee. Employer contributions are rare or nonexistent in GPFs. Employee contributions qualify for tax deductions under the applicable investment allowance provisions.

### **Recognized Provident Fund (RPF)**

A Recognized Provident Fund (RPF) is one where both the employee and employer contribute. While employer contributions to the RPF are taxable, employee contributions are eligible for tax deductions. At retirement, the accumulated balance (excluding the employee's contribution) is taxable, unless specific exemptions apply.

### **Unrecognized Provident Fund**

In an Unrecognized Provident Fund, the employer's contributions are fully taxable, as is the accumulated balance at the time of retirement. Since these funds do not meet the criteria for tax exemptions under the Bangladesh Income Tax Act, the entire amount is treated as income. Non-assessable income under the head "income from employment":

In Part 1 of Sixth Schedule of the Income Tax Act, 2023, some income relating to salary have been mentioned as non-assessable:

- i) One third of income from employment or Tk 450,000 (whichever is lower) shall be deducted from 'Income from Employment' (Sixth Schedule, Part 1, Para 27)
- ii) The income of any employee of intergovernmental organization or any international organization tax of which is exempted by under any Act passed by the parliament or under any agreement signed by the Government. (Sixth Schedule, Part 1, Para 1)
- iii) Remuneration received from the Government by virtue of their employment by Ambassador, High Commissioner, Envoy, Minister, Charge the Affairs, Commissioner, Councillor, Consul the Career, Secretary, Advisor or Atache of Ambacy, High Commission, Legation or commission of a foreign State. (Sixth Schedule, Part 1, Para 2)
- iv) Any income received by a trade commissioner or other official representative in Bangladesh of a foreign State (not holding office as such in an honorary capacity) as his official salary, if the official salary of the corresponding officials, if any, of the Government, resident for similar purposes in the country concerned, enjoy a similar exemption in that country. (Sixth Schedule, Part 1, Para 2)
- v) Any income by a member of the staff of any of the officials referred to above (i.e. ii and iii), as his official salary, when such member is not a citizen of Bangladesh and is either a subject to the country represented or a subject of some other foreign State and is not engaged in any business or profession or employment in Bangladesh otherwise than as a member of such staff, and the country represented has made corresponding provision for similar exemptions in the case of member of the staff of the corresponding officials of the Government of the People's Republic of Bangladesh in that country. (Sixth Schedule, Part 1, Para 2)
- vi) Any pension due or received from the Government. (Sixth Schedule, Part 1, Para 4)
- vii) Any gratuity up to taka two crore fifty lakh received from Government Pension Fund. (Sixth Schedule, Part 1, Para 5)
- viii) Any recognized provident fund, approved superannuation fund, pension fund, approved gratuity fund a) Any contribution received by the employee and employer; and b) Income distributed to the beneficiary thereof from which the fund is liable to tax Provided that the amount received by the taxpayer as gratuity from by approved gratuity fund does not exceed the limit two crore fifty lakh. (Sixth Schedule, Part 1, Para 6)
- ix) Any income from a provident fund established under the Provident Fund Act, 1925. (Sixth Schedule, Part 1, Para 7)
- x) any amount received by any employee of a Government body, local authority or autonomous or semiautonomous body and their controlled units or institutions on voluntary retirement under any scheme approved by the Government for this purpose. (Sixth Schedule, Part 1, Para 8).

In addition to above, Board or Government exempted some employment income through issuing SROs, namely –

- a) According to SRO 182law/99, dated 1 July 1999, if salary tax is paid by employer, tax shall not be applicable on such paid tax.

- b) According to SRO 298/2015 dated 8 October 2015, foreign expatriate having technical knowledge employed by any company, operating for production of goods or rendering service in any Economic Zone (as declared and established under section 5 and 4 respectively, of Bangladesh Economic Zone Act 2010), 50% of tax payable by him/her will be exempted from income tax for 3 years from appointment by said company.

### **Tax rebate on certain investment**

According to section 78 of Income Tax Act, 2023, resident individual and non-resident Bangladeshi shall be entitle to tax rebate as under: Lower of :

- (i) Where,  $0.03 \times A$  ; or
- (ii)  $0.15 \times B$  ; or
- (iii) Tk 10 lakh.

A = Computed total income excluding tax exempted income, income subject to reduced tax rate, income subject to minimum tax.

B = Total investment and expenditure of the taxpayer as per Part 3 of Sixth Schedule.

### **Items included in investment allowance related to salary income**

From basic salary, the employer can deduct a certain amount of money under various heads according to the contract between employer and employee. Of those some of the deductions are included in the items of investment allowance for which tax rebate is admissible: As per the regulations of Part 3 of Sixth Schedule of the Income Tax Act, 2023, the following salary items are considered as a part of the investment allowance:

- i) Any sum deducted from salary to a deferred annuity or for making provisions for his wife or children, provided that the sum so deducted shall not exceed one-fifth of the salary. (Para 3)
- ii) Employee's contribution to a General Provident Fund [GPF]. (Para 4)
- iii) Employee's and Employer's contribution to RPF (Para 5)
- iv) Ordinary annual contribution to approved superannuation fund. (Para 6)
- v) Employee's contribution to a benevolent fund or group insurance scheme. (Para 12).



## Lesson – 2: Charges of Tax

### Lesson Objectives

After completing the lesson, you will be able to:

- Insights into the charge of income tax, surcharges, additional taxes, and minimum tax.
- Aware of special tax exemptions and rates.
- Familiar with taxpayer identification mechanisms and registration processes.

### Tax rates:

The threshold limit of total Income not liable to Income tax for the assessment year 202425 stands at Tk. 3,50,000. Tax exempted ceiling of income for female assessee, and senior citizens ageing 65 or above is Tk. 4,00,000 and that for 3rd gender assessee, handicapped/disabled persons is Tk. 4,75,000 and for gazated war wounded freedom fighter is Tk. 5,00,000 for the assessment year 202324. The threshold limit in case of parents or legal guardian of any person with disability will be Tk. 50,000 more. If both father and mother of the disabled person is assessee then any one will avail this benefit.

The 6 tier tax rates for the assessment year 2024-25 are given below:

Tier	Income Slab	Tax Rate
1	First Tk. 350,000	0%
2	Next Tk. 100,000	5%
3	Next Tk. 300,000	10%
4	Next Tk. 400,000	15%
5	Next Tk. 500,000	20%
6	On rest of income 25%	25%

If the assessee is an owner of any small and cottage industry or engaged in such kind of activities at less developed / least developed area as specified by the NBR, he/she will be eligible to have a tax rebate on such income at following rates:

- (a) If production / turnover increase by more than 15% but less than 25% comparing to previous year, then 5% tax rebate will be allowed;
- (b) If production / turnover increase by more than 25% comparing to previous year, rate of rebate will be 10%.

**Non-residents:** Non-residents other than Bangladeshi non-residents shall pay tax on the total income at flat rate of 30%.

**Statement of assets, liabilities and lifestyle:** An individual assessee must submit the statement of assets, liabilities and lifestyle, if he

- a) Has a gross wealth over Taka 5 million [earlier it was Taka 4 million];
- b) Owns a motor car; or
- c) Has made an investment in a house property or an apartment in the city corporation area.

If any individual, not being a shareholder director, has total income not exceeding Taka 0.5 million without from business, he may opt not to submit the statement of lifestyle. Nonresident Bangladeshi and non-Bangladeshi shall submit the assets and liabilities statements only in respect of assets located in Bangladesh.

## Capital Gains Tax:

**Trust and funds:** flat 15% instead of earlier 15% or slab rate.

**Company and firm:** flat 15% instead of earlier 10%.

**Individuals:** transfer of sponsor, director or placement share or unit is 15% instead of earlier 5%.

**Individuals:** transfer of listed share or unit (other than sponsor, director or placement share or unit) is 15% or slab rate unless the gain exceeded Taka 5 million [earlier full amount was exempted].

**Income from rent:** The scope of rental income has been broaden and segregated into house property and other than house property.

- Allowable deductions will also be separately accounted for.
- Renting of hostel, hotel, motel or resort will not be considered as rental income. Repair maintenance deduction at 10% for other assets has been proposed to be deleted.
- However, deductions of business income will be applicable for renting of other than house property.

**Special Business Income:** Inadmissible expenses in respect of perquisite, royalty/license fee/technical know how fees, head office expense of branch, foreign travel, entertainment, free sample, promotional expense, expense calculated without precise calculation (provision), impairment loss will not be considered as special business income in addition to earlier amortisation of RoU assets.

## Tax Rates for corporate:

Companies	Proposed Rate
Publicly traded companies listed more than 10% of their paid up capital through IPO	20%
Publicly traded companies listed 10% or less of their paid up capital through IPO	22.5%
One person company	20%
Non listed companies other than below	25%
Banks, insurance and other financial institutions (except merchant banks): if publicly listed	37.5%
if not publicly listed	40%
Merchant banks	37.5%
Cigarette, zarda, bidi, gul or any other tobacco product manufacturer (companies and any other assessee)	45%
Surcharge in addition to above tax is applicable on business income.	2.5%
Mobile phone operator companies [opportunity to apply tax rate at 40% for listing with stock exchange has been eliminated]	45%
Trust, Fund, Association of persons, and other taxable entities	27.5%
Cooperative society	20%
Private university, private medical college, private dental college, private engineering college or private college engaged in information technology education	15%
Recognised provident fund, approved gratuity fund, approved superannuation fund or pension fund	15%

All income and receipts, and all expenses and investments over Taka 0.5 million for a single transaction and over Taka 3.6 million in a year shall be made through bank transfer.

Surcharge has been proposed to decrease at 2.5% in place of earlier of 5% for educational institutions if these entities fail to ensure proper arrangement for movement of disabled person. On the other hand, rebate of 5% tax or waiver of 75% of salary to physically challenged or third gender employees, whichever is lower, will be allowed for employing 10% of total employees or more than 25 persons from physically challenged or third gender persons.

### Surcharge

A surcharge is levied on the income tax payable by certain high income earners. The rates and thresholds are specified annually in the Finance Act.

Total net worth	Rates
Rate Up to Taka 40 million	Nil
Over Taka 40 million to Taka 100 million or owner of more than 1 motor car or owner of house property of more than 8,000 sft size	10%
Over Taka 100 million to Taka 200 million	20%
Over Taka 200 million to Taka 500 million	30%
Over Taka 500 million	35%

### Additional Tax and Additional Amount

**Additional Tax:** This is levied on taxpayers who fail to file returns on time or underreport income. It can include:

- Interest on unpaid taxes, typically at a rate of 2% per month.
- Penalties for failure to comply with tax regulations, which may vary depending on the severity of the noncompliance.

### Minimum Tax:

The minimum tax ensures that even if a company reports no income or incurs losses, it is required to pay a minimum amount of tax. This applies primarily to companies with gross receipts above a specified threshold.

Location	Minimum tax
Within Dhaka North City corporation, Dhaka South City Corporation and Chattogram City Corporation	Taka 5,000
Any other City Corporation	Taka 4,000
Other than City Corporation area	Taka 3,000

### Special Tax Exemptions:

1. If an individual pays for life insurance or a contract for deferred annuity (a plan that starts paying at a later date), either for themselves, their spouse, or minor child, the tax deduction is limited to 10% of the insurance amount (excluding bonuses or additional benefits).
2. A Hindu undivided family (HUF) can claim tax benefits if they pay for life insurance for any male family member or his wife. However, this benefit will only be available if both the insurance premium and payout are within Bangladesh.

3. Government employees can claim tax deductions if a portion of their salary is deducted for securing a deferred annuity or providing for their spouse and children. This deduction cannot exceed one fifth of the salary.
4. Contributions made by an individual to a provident fund (a retirement savings fund) under the Provident Fund Act, 1925, are tax deductible.
5. Contributions to a recognized provident fund, both from the individual and their employer, are eligible for tax benefits, but there are certain limits specified in the First Schedule of the tax rules.
6. Contributions made to an approved superannuation fund (another type of retirement fund) by the individual can also be deducted from taxable income.
7. An individual (not a company) can get tax benefits by investing in the following:
  - Savings certificates or instruments specified by the tax authority.
  - Unit certificates and mutual fund certificates from financial institutions or the Investment Corporation of Bangladesh.
  - Certain government securities (like development loans or bonds) as specified by the tax authority.
  - Shares from investment companies specified by the tax authority.
8. An individual can claim a tax deduction for investments up to Tk 60,000 in a deposit pension scheme offered by a scheduled bank or financial institution.
9. Donations made to a charitable hospital outside a city corporation area that has been operating for at least one year and is approved by the tax authority are eligible for a tax deduction.
10. Donations made to an organization working for the welfare of people with disabilities (retarded people), which has been established for at least one year and is approved by both the Social Welfare Department and the tax authority, are tax deductible.
11. Donations made as Zakat (Islamic charity) to the Zakat Fund or other charitable funds set up under the Zakat Fund Ordinance, 1982, are tax exempt.
12. If a person receives income from an association of persons (not including companies, firms, or HUFs) where the association has already paid tax, that income is exempt from further taxation.
13. If a person receives income from a firm where tax has already been paid by the firm, that income is also exempt from tax.
14. An individual can claim a tax deduction for contributions made to a benevolent fund (a fund for welfare) or for premiums paid under an approved group insurance scheme to provide for their family.
15. Donations made to socioeconomic or cultural development institutions in Bangladesh, established by the Aga Khan Development Network, are tax deductible.
16. Donations to government approved philanthropic or educational institutions are eligible for a tax deduction.
17. An individual can claim a deduction for the purchase of one computer or laptop.
18. Donations made to national level institutions set up in memory of the Liberation War are tax deductible.
19. Donations made to national level institutions set up in memory of the Father of the Nation are also tax deductible.

20. An individual can claim tax deductions for investments in stocks, shares, mutual funds, or debentures listed on any stock exchange.
21. Investments in Bangladesh Government Treasury Bonds are eligible for tax deductions.

### **Taxpayer Identification Number (TIN)**

The TIN is a unique number assigned to each taxpayer by the NBR. It is mandatory for:

- Filing income tax returns.
- Conducting any tax-related transactions.

### **Tax Collection Account Number (TCAN)**

The TCAN is a specific account number used for making tax payments. Taxpayers use this number to ensure that their payments are properly tracked and recorded.

### **Unified Taxpayer Identification Number (UTIN)**

The UTIN consolidates all taxpayer information under one unique identifier to streamline tax administration and facilitate easier access for both taxpayers and authorities.

### **Issuance of Temporary Registration Number**

A temporary registration number may be issued to individuals or entities awaiting a TIN or UTIN. This allows them to comply with tax obligations in the interim, ensuring they can engage in tax-related activities while their permanent identification is processed.

### **Relevant Questions:**

1. What is the significance of the income year and assessment year in Bangladesh?
2. How do you compute total income under the current tax laws?
3. What are the key components of the charge of income tax in Bangladesh?
4. Explain the criteria for applying surcharges on income tax.
5. What constitutes additional taxes, and what triggers them?
6. Describe the minimum tax provision and its implications for companies.
7. What are the current individual tax rates in Bangladesh?
8. What corporate tax rates apply to different sectors in Bangladesh?
9. What types of income are eligible for special tax exemptions?
10. Why is a Taxpayer Identification Number (TIN) essential?
11. How does the Tax Collection Account Number (TCAN) function in tax payments?
12. What benefits does the Unified Taxpayer Identification Number (UTIN) provide?
13. What is the process for obtaining a temporary registration number in Bangladesh?

### **References:**

Institute of Chartered Accountants of Bangladesh. (2023). *Tax Planning and Compliance: Professional level* (6th ed.). ICAB.

Shil, N. C. (2022). *Bangladesh income tax: Theory and practice* (12th ed.). CSM Foundation.



## Assessment of Individuals

4

### Unit Highlights

- Definition of individuals;
- Assessment procedure;
- Specimen form of Computation of total income and tax liability;

### Technologies Used for Content Delivery

- ❖ BOUTUBE
- ❖ BOU LMS
- ❖ WebTV
- ❖ Web Radio
- ❖ Mobile Technology with MicroSD Card
- ❖ BTV Program
- ❖ Bangladesh Betar Program





## **Lesson- 1: Assessment of Individuals**

### **Lesson Objectives**

After completing the lesson, you will be able to:

- Understand tax assessment procedure of individuals in Bangladesh.
- Compute total income and tax liability of individuals.

### **Definition of individuals**

The word 'individual' has special meaning in income tax law. To look at its reference in tax law, we should look at two definitions, i.e., assessee and person.

"Assessee", means a person by whom any tax or other sum of money is payable under ITA, 2023, and includes –

- (a) Every person in respect of whom any proceeding under ITA, 2023 has been taken for the assessment of his income or the income of any other person in respect of which he is assessable, or of the amount of refund due to him or to such other person;
- (b) Every person who is required to file a return under section 166, 191 or 193;
- (c) Every person who desires to be assessed and submits his return of income under ITA, 2023; and
- (d) Every person who is deemed to be an assessee, or an assessee in default, under any provision of ITA, 2023 [Section 2(22)].

"Person" includes an individual, a firm, and an AOP, a HUF, a trust, a fund, a company, an entity [Section 2 (69)]. Thus, the word 'assessee' means a person that includes an individual who is liable to pay tax as per Income Tax Act, 2023. This chapter represents the assessment of income of individuals and computation of tax liability of an individual assessee.

### **Procedure of assessment**

**Step 1:** Compute taxable income under different heads. [Don't forget to exclude non-assessable income and grossing up of income at the time of computing taxable income in specified areas]

**Step 2:** Compute allowable investments made [Don't forget to test actual investment so that it must not exceed the maximum limit. If it exceeds maximum limit, allowable investment would be the lower one]

**Step 3:** Compute net tax liability [Don't forget to consider tax credit due to TDS, refund adjustment, rebate, foreign tax credit and rebate on income from partnership firm].

### **Tax rates of individuals**

Individuals are taxed as per the 5-tier taxation system in Bangladesh. However, these rates are same for every individual including Bangladeshi non-residents, HUF and Partnership Firm. Current rates applicable to individuals on total taxable income for the assessment year 2023-24 are:

Slab	Rate
First Tk. 3,50,000	0%
Next Tk. 1,00,000	5%
Next Tk. 3,00,000	10%
Next Tk. 4,00,000	15%
Next Tk. 5,00,000	20%
Remaining Balance	25%

- a) The non-assessable income limit will be as follows:
- For women, and elderly male citizens being 65 years of age or more is Tk. 4,00,000
  - For disable persons is Tk. 4,75,000
  - For Gazetted war wounded freedom fighter is Tk. 5,00,000
  - For 3rd gender assessee is Tk. 4,75,000
  - For being father of disable children is Tk. 3,50,000 or For being mother of disable children is Tk. 4,00,000
- b) If the aggregate income of an individual assessee exceeds Tk. 16,50,000 (Tk. 3,50,000 + Tk. 1,00,000 + Tk. 3,00,000 + Tk. 4,00,000 + Tk. 5,00,000), he will be charged @ 25% on such income as it exceeds Tk.16,50,000.
- c) However, the minimum tax would be Tk. 5,000 or Tk. 4,000 or Tk.3,000 depending on the location of the assessee.
- d) If the assessee is an owner of any small and cottage industry or engaged in such kind of activities in a NBR specified less developed / least developed area, he/she will be eligible to have a tax rebate on such income: [Finance Act, 2023] If production / turnover increases by more than 15% but less than 25% comparing to previous year 5% rebate on tax applicable on such income will be allowed. If production / turnover increases by more than 25% comparing to previous year 10% rebate on tax applicable on such income will be allowed
- e) Only individual assessee having net wealth exceeding Tk. 4 crore as per statement of assets and liabilities is liable to pay surcharge @10% on income tax payable and in case net wealth exceeds Tk. 10 crore but does not exceed 20 crore then surcharge is to be paid @20%, if wealth exceeds Tk. 20 crore but does not exceed 50 crore then surcharge is to be paid @30%, and if it exceeds 50 crore then the rate of surcharge will be 35%. f) However, the rate of tax would be straight 30% (at maximum rate) if the individual assessee is classified as non-resident foreigner (NRF).

### Specimen form of computation of total income and total tax liability

<b>1. Employment (Section 32 - 34)</b>		
<b>Particulars</b>	<b>Amount (Tk.)</b>	<b>Amount (Tk.)</b>
Basic Salary	***	***
Dearness allowance	***	***
Annuity	***	***
Employees share scheme (Fair market value less Acquisition cost)	***	***
Festival bonus / performance bonus	***	***
Leave encashment / Compensation	***	***
Employer's contribution to recognized provident fund	***	***
Entertainment allowance	***	***
Medical allowance	***	***
House-rent allowance	***	***
Advance salary / outstanding salary	***	***
Conveyance allowance	***	***
Car facility: up to 2500 CC - 10,000 per month; above 2500 CC - 25,000 per month	***	***
Rent free accommodation: Annual rental value	***	***
Accommodation at a concessional rate	***	***
The annual rental value Less: rent paid by the employee	***	***
Taxable portion of Interest on recognized provident fund	***	***
Retirement allowance / gratuity / pension	***	***

Less: exempted pension full, gratuity up to Tk.2.5 crore	***	***
Other benefits (actual or fair value)	***	***
Total income from employment	***	***
Less: 1/3 of total income from employment or 4,50,000, whichever is lower	***	***
<b>2. Income from Rent (Section 35 - 39)</b>		
Rental value	***	***
Add: TDS (If any)	***	***
Add: Owner's expenses paid by the tenant	***	***
Less: Tenant's expenses paid by the owner	***	***
Actual rental value	***	***
Higher of annual value and actual rental value	***	***
Add: Advance rent	***	***
Add: Any receipts or sum other than rental value or advance rent	***	***
Less: Adjusted advance rent which received previously	***	***
Less: Vacancy allowance	***	***
Rental income	***	***
Repair & maintenance expenses	***	***
Land development tax	***	***
Insurance Premium	***	***
Interest payable on house building Loan	***	***

Annual tax [Municipal or local authority tax]	***	***
<b>3. Agricultural Income (Section 40 - 43)</b>		
Sale of crops	***	***
Income from any land or building used for agricultural purposes	***	***
Income from granting a right ['Borga']	***	***
Income from tea garden or rubber garden [60%]	***	***
Revenue profit by sale of discarded or demolished agricultural machineries	***	***
Other income relating to agriculture	***	***
Land development tax	***	***
Any taxes [local taxes, etc.]	***	***
Production costs	***	***
Ordinary processing costs to make crop marketable	***	***
Transportation cost of crops or livestock to market	***	***
Maintenance cost of agricultural equipment & up keeping of cattle for cultivation	***	***
If proper books of accounts do not maintained an expenditure equivalent to 60% of sales proceeds is allowed as admissible expense	***	***
Insurance premium	***	***
Repair and maintenance of irrigation plant	***	***

Depreciation	***	***
Interest on mortgage loan	***	***
Interest on borrowed capital	***	***
Loss due to discard/demolish of agricultural machineries	***	***
Other revenue expenses	***	***
<b>4. Income from Business (Sec. 44 - 56)</b>		
Net Profit (P&L A/C)	***	***
Add: Inadmissible Expenses	***	***
Add: Unincluded Income	***	***
Less: Allowable Expenses (not in P&L)	***	***
Total Income	***	***
Less: Non-business Income already credited	***	***
<b>5. Capital Gain (Sec. 57 - 61)</b>		
Sale Proceeds/FMV	***	***
Less: Expenses on Transfer	***	***
- Cost of Acquisition	***	***
- Capital Improvements	***	***
Capital Gain	***	***
<b>6. Income from Financial Assets (Sec. 62 - 65)</b>		
Interest - Govt. Securities	***	***
Less: Bank Charge & Borrowed Fund Interest	***	***
Interest - Islamic Securities	***	***
Wage Earner Dev. Bond	***	***
Less: Exemption (full)	***	***
Zero Coupon Bond	***	***

Less: Exemption (full)	***	***
Dividend Income	***	***
Bank Deposit Interest [×100/90]	***	***
Savings Certificate [×100/90]	***	***
Post Office SB Interest [×100/90]	***	***
Mutual/Unit Fund Dividend [×100/90]	***	***
<b>7. Income from Other Sources (Sec. 66 - 69)</b>		
Commission/Fee (Non-employer)	***	***
Royalty from Books	***	***
Lottery/Prize Bond [×100/80]	***	***
Director's Fee	***	***
Non-agri Income (fish, fruits, etc.)	***	***
Invigilation/Script Evaluation	***	***
Writing/Articles in Newspapers	***	***
TV/Radio/Cultural Programs	***	***
Lease Income (Non-agri Land)	***	***
Tuition Income	***	***
Underwriting Commission	***	***
Patent/License Income	***	***
Rent from Boat/Appliances	***	***
Unexplained Investments	***	***
Other Miscellaneous Income	***	***
Less: Deductions u/s 68 (loan interest, etc.)	***	***

<b>8. Share of profit in a partnership firm</b>
<b>9. Spouse/Minor Child Income</b>

### Tax Liability Calculation

Slab	Rate	Amount (Tk.)
First Tk. 3,50,000	0%	-
Next Tk. 1,00,000	5%	*****
Next Tk. 3,00,000	10%	*****
Next Tk. 4,00,000	15%	*****
Next Tk. 5,00,000	20%	*****
Remaining Balance	25%	*****
Total Tax		*****
Less: Investment Tax Rebate		*****
Less: Rebate on Partnership Income		*****
Less: Foreign Tax Credit		*****
Less: TDS/Advance Paid		*****
Less: Previous Tax Refund		*****
Net Tax Liability		*****

### Practical Problems

#### Problem 1:

The following are the particulars of income of Ms. Suchana Saha for the year ended 30th June, 2024.

1. Basic salary: Tk. 20,000/-per month
2. Dearness allowance at 40% of base salary, with a monthly maximum of Tk 5,000 per month
3. Bonus: equal to two months' basic pay.
4. A monthly entertainment allowance of Tk 500.
5. Crop sales revenue from agricultural land (Tk. 23,000)
6. Tk 30,000 honorarium as a part-time advisor
7. Tk 50,000 (taxed) income from a partnership business.
8. Tk. 7,500 in revenue from commercial securities.
9. Tk 25,000 in interest on a pensioner savings certificate.
10. Tk 9,000 in royalties from books.



**Housing facilities:** A free quarter-annual rental worth Tk. 40,000 was given to Mr. Fazal. Additionally, he owns a residence that is rented out for Tk 20,000 a month. The reasonable rent for the residence is Tk. 2,00,000. He paid Tk. 40,000 for the alteration and Tk 10,000 for the repair. In addition, he paid Tk. 5,000 for municipal taxes, Tk. 3,500 for fire insurance, and Tk. 3,000 for legal fees.

Solution:

<b>Computation of Total income of Ms. Suchana Saha</b> <b>Income Year: 2023-24</b> <b>Assessment Year: 2024-25</b>			
Particulars	Amount	Amount	Amount
<b>Income from employment: Sec 32</b>			
Basic Salary: Tk. 20,000 Monthly		240,000	
Dearness allowance: 40% of Basic pay Maximum:	96,000		
Maximum	60,000		
Entertainment Allowance: 400X12		60,000	
Bonus (2 month's Basic Salary)		40,000	
Entertainment Allowance		6,000	
Housing facility: Annual rental value		40,000	
Employer's contribution to RPF: 10% of B. S.		24,000	
Income from employment		410,000	
Less: Exempted - 1/3 of income from total employment or 450,000, whichever is lower		(136,667)	
			<b>273,333</b>
<b>Income from rent (Section 35)</b>			
Annual Rental Value:	240,000		
Or, reasonable rent (Higher one is assessed value)	200,000		

Or, reasonable rent (Higher one is A.V.)		240,000	
<u>Less: admissible deductions:</u>			
Repair 25% the of assesed value	60,000		
Municipal tax	5,000		
Fire insurance	3,500		
		<b>68,500</b>	
			<b>171,500</b>
<b>Income from Agriculture: (Section 40)</b>			
Sale of crops		23,000	
Less Cost of production @ 60%		(13,800)	
			<b>9,200</b>
<b>Income from Business: (Section 44)</b>			
<b>Income from Partnership Business (taxed income)</b>			<b>50,000</b>
<b>Income from financial assets (Section 62)</b>			
<b>Income from Commercial Securities</b>			<b>7,500</b>
<b>Income from other sources: (Section 66)</b>			
Honorarium as part-time advisor		30,000	
Royalty from books		9,000	
			<b>39,000</b>
<b>Total taxable income</b>			<b>550,533</b>

<b><u>Tax calculation</u></b>	<b>Total Income</b>	<b>Tax rate</b>	<b>Tax</b>
Tax on 1st 4,00,000	400,000	0	0
Next upto 1,00,000	100,000	5%	5,000
Balance	50,533	10%	5,053
Total tax liability			10,053
Less: Rebate on income from partnership firm at average rate (50,000x5,000/550,533)			(454)
<b>Net tax liability</b>			<b>9,599</b>

### **Problem 2:**

Mr. Akash is an engineer at a private company. His list of income for the year ended 30<sup>th</sup> June, 2024 were as follows:

#### **Income from employment:**

1. Basic salary per month Tk. 60,000
2. House rent allowance per month 40,000
3. Conveyance allowance per month 4,000
4. Fair value of share scheme received is 50,000
5. Medical allowance per month (actual exp. Tk. 20,000) 3,000
6. Employer's Contribution to RPF 10% of Basic.

#### **Agricultural income:**

1. Tk 45,000 from the sale of pond fish (not fish farming)
2. Crop sales of Tk 2,70,000

#### **Income from financial asset:**

Dividend from listed company Tk. 30,000

#### **Income from other sources:**

Income from lease of non-agricultural land Tk. 40,000.

In addition to all of these, Mr. Akash also made some investments:

1. Tk 45,000 was paid for the life insurance premium; the policy was worth Tk 3,00,000.
2. Tk. 10,000 was donated to a local club;

3. Tk. 15,000 was donated to a local mosque;
4. Tk. 20,000 was given as a gift to the wife;
5. Tk. 70,000 was invested in primary shares of listed companies;
6. Tk. 40,000 was spent on a savings certificate;
7. Tk. 50,000 was donated to a charitable hospital;

From the above particulars of Mr. Akash compute total income and tax liability for the assessment year 2024-25.

### Solution

<b>Mr. Akash</b> <b>Income year: 2023-24</b> <b>Assessment year: 2024-25</b>			
<b>Computation of total income</b>			
<b>Income from employment (section: 32):</b>			
Basic salary (60,000 X 12)		720,000	
House rent allowance: (40,000 X 12		480,000	
Conveyance allowance (4,000 X 12)		48,000	
Medical allowance (3,000 X 12)		36,000	
Share scheme		50,000	
Employer's contribution to RPF		72,000	
<b>Income from employment</b>		<b>1,406,000</b>	
Less: Exempted - 1/3 of income from total employment or 450,000, whichever is lower		-450,000	
			956,000
<b>Agricultural income (section: 40):</b>			

Crop sales			270,000
<b>Income from financial assets (section: 62):</b>			
Dividend from listed company			30,000
Income from other sources (section: 66):			
Sale of pond fish (not fish farming)		45,000	
Income from lease of non-agricultural land		40,000	
			85,000
<b>Total taxable income</b>			<b>1,341,000</b>
<b>Calculation of allowable investment rebate</b>			
Life insurance premium (maximum up to 10% of policy value)		30,000	
Investment in primary share of listed companies		70,000	
Contribution to RPF (Tk. 72000 × 2)		144,000	
Purchase of savings certificate		40,000	
Donation to:			
Charitable hospital (assuming govt. approved)		50,000	
<b>Actual investment</b>		<b>334,000</b>	
Maximum limit:			
15% of actual investment;		50,100	

3% of total income (1,341,000 X 3%);		40,230	
Or 10,00,000		1,000,000	
<b>Whichever is lower allowable for investment rebate</b>		<b>40,230</b>	
<b><u>Tax calculation</u></b>			
Tax on 1st 3,50,000	<b>Total Income</b>	<b>Tax rate</b>	<b>Tax</b>
Next upto 1,00,000	100,000	5%	5,000
Next upto 3,00,000	300,000	10%	30,000
Next upto 4,00,000	400,000	15%	60,000
Next upto 5,00,000	500,000	20%	100,000
Balance	41,000	25%	10,250
<b>Total tax liability</b>			<b>205,250</b>
Less: Investment tax rebate			(40,230)
<b>Net tax liability</b>			<b>165,020</b>

### Problem 3:

Mrs. Asma Khatun works a private job in a multinational company. Her sources of income for the year ended on 30th June, 2024 were as follows:

#### Income from Employment:

1. Monthly Basic Salary: Tk. 180,000.
2. Dearness allowance 10% of base pay;
3. Rent free quarter with an annual value of 2,50,000
4. Medical reimbursement Tk 120,000 annually (the real cost for the year was Tk 100,000).
5. Two bonuses equal to two months' base pay;

6. Allowance for entertainment Tk. 1200 monthly
7. A complimentary automobile (above 2500 CC) has been given to him for both official and private use.
8. Travel allowance: 100,000; actual expense – 90,000
9. She makes an RPF contribution of 10% of his base pay. His employer made the same contribution.
10. She earned Tk 30,000 at 14% on RPF during the year.

**Income from agriculture:**

1,12,000 was made from the sale of paddy from agricultural land provided on the Barga system. In addition, Tk 12,000 was made from the sale of trees that grew naturally on Mr. Quader's property.

**Capital Gains:**

1. Tk 200,000 in profit from the selling of shares of a private limited company
2. Tk 50,000 was made from the selling of shares of a publicly traded company.

During the year Ms. Asma made the following investments –

1. Life insurance premium Tk. 50,000 (Policy Value Tk. 800,000)
2. Investment in shares of a listed company Tk. 120,000
3. Donation to charitable institutions as approved by NBR Tk.100,000.

From the above particulars of Ms. Asma compute total income and tax liability for the assessment year 2024-25.

**Solution:**

<b>Asma Khatun</b> <b>Income year: 2023-24</b> <b>Assessment year: 2024-25</b>			
<b>Computation of total income</b>			
<b>Particulars</b>	<b>Amount</b>	<b>Amount</b>	<b>Amount</b>
<b>Income from employment: Sec 32</b>			
Basic salary (150,000 X 12)		2,160,000	
Dearness allowance (2,160,000 × 10%)		216,000	
Housing facility: Annual rental value		250,000	

Medical allowance		120,000	
Bonus (18,00,000 × 2)		360,000	
Entertainment allowance (1200 X 12)		14,400	
Car facility (25,000 X 12)		300,000	
Travel allowance	100,000		
Less: Exempted – up to actual expense	(90,000)		
		10,000	
Employer's contribution to RPF (10% of basic)		216,000	
Interest from RPF		300,000	
<b>Total income from employment</b>		<b>3,946,400</b>	
Less: Exempted - 1/3 of income from total employment or 450,000, whichever is lower		(450,000)	
			3,496,400
<b>Income from agriculture (Section 40)</b>			
Sales of paddy			112,000
<b>Income from capital gains (Section 57)</b>			
Profit on sale of shares of private limited company		200,000	
Profit on sale of shares of public limited company	50,000		
Less: Exempted fully as per 6th Schedule	(50,000)		



		-	
			200,000
<b>Income from other sources (Section 66)</b>			
Sale of naturally grown trees			12,000
<b>Total taxable income</b>			<b>3,820,400</b>
<b>Calculation of allowable investment rebate</b>			
Life insurance premium (maximum up to 10% of policy value)		80,000	
Investment in primary share of listed companies		120,000	
Donation to charitable institute		100,000	
<b>Actual investment</b>		<b>300,000</b>	
Maximum limit:			
15% of actual investment;		45,000	
3% of total income (1,341,000 X 3%);		114,612	
Or 10,00,000		1,000,000	
<b>Whichever is lower allowable for investment rebate</b>		<b>45,000</b>	
<b><u>Tax calculation</u></b>	<b>Total Income</b>	<b>Tax rate</b>	<b>Tax</b>
Tax on 1st 4,00,000	400,000	0	0
Next upto 1,00,000	100,000	5%	5,000
Next upto 3,00,000	300,000	10%	30,000

Next upto 4,00,000	400,000	15%	60,000
Next upto 5,00,000	500,000	20%	100,000
Balance	2,120,400	25%	530,100
<b>Total tax liability</b>			<b>725,100</b>
Less: Investment tax rebate			(45,000)
<b>Net tax liability</b>			<b>680,100</b>

### Relevant Question

Mr. Jamshed Hasan is an executive of a private firm. He furnished the following information for the income year 2023-24. Compute his total income and tax liability for the assessment year 2024-25.

#### Income from salaries:

- i. Basic salary Tk. 33,000 per month;
- ii. Festival bonus equivalent to two months basic salary;
- iii. House rent allowance Tk. 15,000 per month;
- iv. Entertainment allowance @ 5% of basic salary;
- v. Medical allowance Tk. 2,000 per month (actual annual expense Tk. 18,000);
- vi. Conveyance allowance Tk. 1,500 per month;
- vii. Contribution to RPF both by employee and employer @ 10% of basic salary

#### Agricultural income:

- i. Sale of crops Tk. 2,70,000;
- ii. Income from sale of fish of pond Tk. 45,000 [not fish farming]

Income from business Tk.32,000

Income from financial asset: i. Interest from fixed deposit Tk. 27,000 [net of tax];

- ii. Interest from savings deposit Tk. 18,000 [net of tax];
- iii. Interest received on post office savings bank Tk. 9,000 [net of tax]

#### Income from other sources:

- i. Income from lease of non-agricultural land Tk. 35,000
- ii. Actual investment made by Mr. Jamshed Hasan during the year is given below.
- iii. Life Insurance Premium paid Tk. 20,000; Policy value Tk. 2,00,000

- iv. Donation to local club Tk. 2,000; Gift to wife Tk. 20,000;
- v. Donation to a local mosque Tk. 5,000;
- vi. Investment in primary shares of listed companies Tk. 60,000;
- vii. Purchase of Savings Certificate Tk. 30,000;
- viii. Donation to a charitable Hospital Tk. 10,000;
- ix. Purchase of furniture Tk. 15,000;
- x. Donation to Apollo Hospital Tk. 30,000;
- xi. Donation to Govt. Zakat Fund Tk. 5,000.

Mr. Jamshed Hasan has Tk. 8,500 refund adjustment from last year and a carry forward of loss from agriculture of Tk. 60,000 for last three years.

**References:**

Institute of Chartered Accountants of Bangladesh. (2023). *Tax Planning and Compliance: Professional level* (6th ed.). ICAB.

Shil, N. C. (2022). *Bangladesh income tax: Theory and practice* (12th ed.). CSM Foundation.



## **Income Tax Authority in Bangladesh**

**5**

### **Unit Highlights**

- Appointment of Income Tax authorities; Types of Income Tax authorities; Delegation of powers; Subordination and control of IT authorities;
- Administrative authorities: Powers and functions;
- Judicial authorities: Powers and function; Tax appeals applicable tribunal;
- Role of civil court regarding income tax; Assistance to income tax authorities.

### **Technologies Used for Content Delivery**

- ❖ BOUTUBE
- ❖ BOU LMS
- ❖ WebTV
- ❖ Web Radio
- ❖ Mobile Technology with MicroSD Card
- ❖ BTV Program
- ❖ Bangladesh Betar Program



## **Lesson- 1: Income Tax Authority, power and Responsibilities**

### **Lesson Objectives**

After completing the lesson, you will be able to:

- Understand the appointment process and structure of income tax authorities in Bangladesh.
- Identify the types of income tax authorities and their specific roles.
- Grasp the delegation of powers and the administrative hierarchy.

### **Appointment of Income Tax Authority**

#### **Overview**

The income tax authority in Bangladesh is a pivotal institution under the Ministry of Finance, primarily responsible for implementing and enforcing the country's income tax laws. This authority operates under the aegis of the **National Board of Revenue (NBR)** and is structured to ensure the efficient collection of taxes, monitoring of taxpayer compliance, resolution of disputes, and formulation of tax policy. The appointment and functioning of the income tax authority are guided by legal frameworks, administrative rules, and government directives to foster transparency, accountability, and responsiveness in the taxation system.

#### **Key Appointments**

##### **Chairman of the National Board of Revenue (NBR):**

The Chairman of the NBR is the highest-ranking official within the income tax administration structure and is appointed directly by the Government of Bangladesh, typically through the Ministry of Public Administration in consultation with the Ministry of Finance.

##### **Responsibilities:**

**Policy Leadership:** The Chairman leads the formulation and implementation of tax policies in line with national fiscal strategies and socio-economic goals.

**Administration Oversight:** Oversees the entire tax administration apparatus including income tax, value-added tax (VAT), customs duties, and other revenues.

**Global Engagement:** Represents Bangladesh in international tax forums, such as the OECD, ADB, IMF, and World Bank. The Chairman often negotiates tax treaties, participates in discussions on base erosion and profit shifting (BEPS), and aligns domestic tax policies with global best practices.

**Reform Implementation:** Spearheads modernization initiatives, digital transformation of tax services, and capacity development of tax officials.

##### **Commissioners of Taxes:**

There are several types of Commissioners appointed across various tax zones and field-level offices. These include Commissioners of Taxes, Additional Commissioners, Joint Commissioners, and Deputy Commissioners. Their appointments are made through government orders, usually among senior officers in the income tax cadre service.

**Responsibilities:**

**Jurisdictional Oversight:** Commissioners are entrusted with overseeing tax assessments, audits, and collections within specific geographic or functional jurisdictions.

**Compliance Enforcement:** Ensure that taxpayers adhere to the provisions of the Income Tax Ordinance, 1984, and relevant rules.

**Taxpayer Services:** Facilitate taxpayer education, resolve disputes, and conduct hearings for appeals and revisions.

**Operational Supervision:** Manage the day-to-day functions of subordinate officers, set performance targets, and monitor progress in revenue collection.

**Tax Officers:**

Tax officers are the frontline personnel responsible for implementing tax laws at the operational level. They are appointed to various ranks based on experience, qualifications, and performance.

**Assistant Commissioner of Taxes (ACT):**

- Entry-level officers appointed through the Bangladesh Civil Service (BCS) examinations.
- Conduct tax assessments, review returns, initiate audits, and respond to taxpayer queries.
- Recommend penalties for non-compliance and refer complex cases to higher authorities.

**Deputy Commissioner of Taxes (DCT):**

- More senior officers who may lead entire tax circles or divisions.
- Responsible for overseeing subordinate staff, managing high-value taxpayers, and ensuring enforcement of legal provisions.
- Play a pivotal role in setting audit priorities and leading anti-tax evasion drives.

**Tax Inspectors and Field Auditors:**

- These officials conduct on-ground inspections and verification of taxpayer records.
- They collect data, identify non-filers, and submit compliance reports to higher authorities.
- Engage directly with small and medium-sized enterprises to educate and enforce tax rules.

**Qualifications and Selection**

Candidates are typically selected through the Bangladesh Civil Service (BCS) examination. Educational qualifications often include degrees in commerce, finance, law, or economics. Experience in tax matters or public administration is preferred for higher positions.



## **Types of Income Tax Authorities**

### **Administrative Authorities**

#### **National Board of Revenue (NBR):**

- Central authority for tax administration.
- Develops tax policies and regulations.
- Monitors compliance and collects taxes.
- Bangladesh is divided into multiple tax zones. Each zone is managed by a Commissioner who oversees assessments and taxpayer services.

### **Judicial Authorities**

#### **Tax Appellate Tribunal (TAT):**

An independent body that hears appeals from taxpayers against decisions made by tax authorities.

Composed of legal experts and tax professionals.

#### **Civil Courts:**

Handle legal challenges related to tax matters.

Provide judicial review of decisions made by the NBR and TAT.

## **Delegation of Powers**

### **Overview**

The delegation of powers is essential for effective tax administration. It allows for specialization and efficiency in handling various aspects of tax compliance and enforcement.

### **Delegation Structure**

#### **Commissioners of Taxes:**

- Have the authority to delegate specific functions to Assistant Commissioners and Inspectors.
- Can assign responsibility for audits, assessments, and taxpayer outreach.

#### **Accountability Mechanism:**

- Delegated powers come with accountability. Each level must adhere to guidelines set by the NBR, and performance is regularly reviewed.

## **Subordination and Control of Income Tax Authorities**

**Hierarchical Structure:** The NBR functions at the top, with regional Commissioners overseeing several districts or zones. Each tax zone operates under a Commissioner, who manages the performance of tax officers and ensures compliance with regulations.

**Responsibilities and Reporting:** Regular reporting between levels ensures that tax policies are implemented uniformly across all jurisdictions. Higher authorities review compliance reports and audit findings to ensure accountability.

## **Administrative Authorities: Powers and Functions**

### **Powers**

#### **Assessment Powers:**

- Conduct assessments of individual and corporate taxpayers based on income reported.
- Review financial statements and supporting documents during audits.

#### **Collection Powers:**

- Authority to collect due taxes, enforce tax laws, and impose penalties for noncompliance.

### **Functions**

#### **Policy Formulation:**

- Develop guidelines for tax assessments, appeals, and compliance.
- Update tax laws as per changing economic conditions and international best practices.

#### **Public Outreach:**

- Conduct workshops and seminars to educate taxpayers about their rights and obligations.
- Publish tax guides and resources to assist taxpayers in understanding tax regulations.

## **Lesson- 2: Judicial Authorities and Public Involvement in Tax Administration**

### **Lesson Objectives**

After completing the lesson, you will be able to:

- Recognize the functions and powers of judicial authorities.
- Comprehend the role of civil courts regarding income tax disputes.
- Identify ways the public can assist tax authorities.

### **Judicial Authorities: Powers and Functions**

#### **(a) Tax Appellate Tribunal (TAT)**

##### **Composition:**

- Comprises a mix of legal professionals and tax experts.
- Ensures impartiality in adjudicating disputes.

##### **Functions:**

- Hear appeals from taxpayers regarding assessments, penalties, and other tax-related decisions.
- Review the legality of tax authority actions and provide interpretations of tax laws.

#### **Civil Courts**

##### **Functionality:**

- Civil courts can review tax matters involving constitutional or legal questions.
- Provide remedies for taxpayers who believe their rights have been violated.

##### **Role of Civil Court Regarding Income Tax**

Civil courts can intervene in income tax matters, particularly in cases involving substantial legal issues or taxpayer rights violations.

They ensure that tax laws are applied fairly and in accordance with the Constitution.

##### **Limitations of Civil Courts**

- Typically do not interfere with the discretionary powers of tax authorities unless there is a clear violation of law or procedural unfairness.
- Appeals against TAT decisions are usually handled in higher courts rather than civil courts.

### **Assistance to Income Tax Authorities**

Assistance comes from various stakeholders, including government agencies, the private sector, and the general public.

#### **Types of Assistance**

##### **Interagency Collaboration:**

Coordination with financial institutions, the Bangladesh Bank, and other government agencies to gather information on taxpayer transactions and compliance.

##### **Legal and Technical Assistance:**

Engagement of legal experts and tax consultants to interpret complex tax laws and provide guidance on compliance.

**Public Cooperation:**

Community outreach programs to raise awareness about tax obligations and encourage voluntary compliance.

Public forums and platforms for taxpayers to express concerns and seek clarifications on tax matters.

**Relevant Questions**

1. What are the qualifications required for the appointment of income tax authorities in Bangladesh?
2. Describe the roles and responsibilities of the National Board of Revenue (NBR).
3. What are the specific functions of the Tax Appellate Tribunal (TAT)?
4. How is power delegated among various levels of income tax authorities?
5. In what ways do civil courts contribute to the oversight of income tax administration?
6. What is the significance of taxpayer education in compliance?
7. How does the administrative structure of tax authorities facilitate effective tax collection?
8. What measures are in place to ensure accountability among income tax officers?
9. Describe the role of public cooperation in supporting income tax authorities.
10. How do judicial authorities differ from administrative authorities in the context of income tax?

**References:**

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## **Nature of Public Expenditure and Sources of Finance in the Public Services**

**6**

### **Unit Highlights**

- Categories and relevance of public expenditure;
- Influences on public expenditure; Demand and supply theories to explain the trends in public expenditure over time;
- The relationship between public expenditure, public services and the prevailing economic climate; Classes and characteristics of public revenue.

### **Technologies Used for Content Delivery**

- ❖ BOUTUBE
- ❖ BOU LMS
- ❖ WebTV
- ❖ Web Radio
- ❖ Mobile Technology with MicroSD Card
- ❖ BTV Program
- ❖ Bangladesh Betar Program



## **Lesson- 1: Nature of Public Expenditure and factors Influencing Public Expenditure**

### **Lesson Objectives**

After completing the lesson, you will be able to:

- Understand key categories of public expenditure (capital and recurrent) and their role in economic growth and social welfare.
- Recognize how governments allocate public expenditure based on priorities and economic conditions.
- Identify economic, social, and political factors shaping public expenditure.
- Analyze how crises impact expenditure patterns and resource allocation.

### **Public Expenditure**

Public expenditure refers to the spending by governments to meet various needs of the economy and society. It can be broadly categorized into several types, each with specific areas of relevance:

#### **Capital Expenditure**

Capital Expenditure (CapEx) refers to government or private sector spending aimed at creating or acquiring physical assets and infrastructure that will provide long-term benefits. These assets can include large-scale projects such as transportation networks (roads, railways, airports), public utilities (water supply, sewage systems), energy infrastructure (power plants, renewable energy facilities), and buildings (schools, hospitals, and government offices). CapEx typically involves significant upfront investment, and the benefits of these projects extend over many years, often decades. It is a critical component of national development, aimed at building or expanding the productive capacity of the economy.

#### **Role of Capital Expenditure:**

**Economic Growth:** CapEx plays a fundamental role in stimulating economic growth. By developing infrastructure, CapEx directly impacts productivity, efficiency, and the overall economy's competitiveness. For example, improved transportation networks reduce the cost and time of moving goods, leading to greater efficiency in trade and commerce. Similarly, the development of energy infrastructure ensures reliable access to power, which is essential for industries and households. Such investments increase the productive capacity of an economy, which in turn drives higher GDP growth over time.

**Job Creation:** Large-scale infrastructure projects funded by CapEx generate both direct and indirect employment opportunities. The construction and operation of new infrastructure require substantial labor input, from engineers and laborers to project managers and maintenance staff. Furthermore, once the infrastructure is operational, it creates additional jobs by facilitating business activity. For example, improved transportation networks not only employ workers during construction but also lead to job growth in sectors such as logistics, retail, and tourism. As these projects are often capital-intensive, they are a key driver of employment, particularly in developing economies.

**Private Sector Participation:** Capital expenditure in infrastructure can also stimulate private sector participation and growth. When the government invests in improving infrastructure, private businesses benefit from better access to markets, reduced logistics costs, and improved resource availability. This, in turn, encourages private investment, entrepreneurship, and

business expansion. For instance, businesses that rely on transportation for distribution benefit from upgraded roads and railways, while energy companies benefit from the development of power plants and renewable energy facilities. By reducing operational costs and increasing efficiency, CapEx investments make economies more attractive for private sector growth and foreign direct investment (FDI).

In summary, capital expenditure is a long-term investment in the economy's infrastructure and productive capacity. It plays a pivotal role in driving economic growth, creating jobs, and fostering private sector development. These investments are essential for improving living standards, enhancing business efficiency, and laying the foundation for sustainable economic development.

## **Revenue Expenditure**

Revenue Expenditure (Rev Ex) refers to the ongoing, recurring costs incurred by the government to maintain its day-to-day operations and deliver public services. Unlike capital expenditure, which creates new assets, revenue expenditure is spent on goods and services that do not lead to the creation of new physical infrastructure or long-term productive assets. Examples of revenue expenditure include paying salaries of public employees, maintaining existing infrastructure, funding operational costs of government services such as education and healthcare, and providing subsidies. While much of this expenditure is essential for government functioning, it is considered non-productive from an economic growth perspective since it does not directly contribute to the creation of new capital assets.

### **Role of Revenue Expenditure:**

**Public Service Delivery:** Revenue expenditure plays a critical role in ensuring the smooth operation of essential government services, which are vital for the functioning of society. These services include public safety (policing and law enforcement), justice (the judiciary system), emergency response (firefighters, disaster relief), and public administration. Without sufficient revenue expenditure, governments would struggle to maintain effective public service delivery, leading to disruption in daily activities and a decrease in overall quality of life for citizens. This is why government spending on these areas is considered indispensable for maintaining social order and well-being.

**Social Stability:** Revenue expenditure is also key to ensuring social stability by supporting programs and services that meet the basic needs of citizens. For instance, subsidies on essential goods like food and fuel, and the provision of services such as healthcare, education, and housing, help prevent social unrest by making sure that the most vulnerable populations have access to necessities. Such programs are especially important in developing economies or during times of economic hardship, where government support can reduce poverty, ensure better living conditions, and promote overall social peace.

**Debt Management:** An important aspect of revenue expenditure is the servicing of government debt, particularly the payment of interest on outstanding loans. Governments often borrow money to finance both capital and revenue expenditures, and servicing this debt is essential for maintaining financial credibility. Timely and efficient debt servicing ensures that a country retains its creditworthiness, avoids default, and keeps borrowing costs manageable. Failure to meet debt obligations can lead to a loss of investor confidence and higher borrowing costs in the future. Therefore, a portion of revenue expenditure is dedicated to interest payments, which helps to maintain financial stability and prevent potential fiscal crises.



In conclusion, revenue expenditure plays an indispensable role in the functioning of the government and society. While it does not directly contribute to the creation of new assets, it ensures the effective delivery of public services, helps maintain social stability, and supports critical debt management functions that safeguard a nation's financial integrity.

## **Transfer Payments**

Transfer Payments refer to government disbursements made to individuals or entities without receiving any goods or services in return. These payments typically include cash benefits such as social security payments, unemployment benefits, welfare assistance, and pensions. Unlike capital or revenue expenditure, transfer payments do not directly contribute to economic production. However, they play a crucial role in supporting individual welfare and promoting social equity by providing a safety net for vulnerable groups.

### **Role of Transfer payments:**

**Income Redistribution:** One of the key functions of transfer payments is to help redistribute wealth and reduce income inequality. By providing financial assistance to vulnerable segments of the population, such as the unemployed, elderly, disabled, or low-income families, these payments act as a tool for wealth redistribution. They ensure that individuals who are less economically secure can maintain a basic standard of living, thus promoting social equity. Through such measures, the government works to alleviate disparities and ensure a more balanced society.

**Economic Stabilizer:** Transfer payments also serve as automatic stabilizers in the economy, especially during periods of economic downturn. For example, unemployment benefits automatically increase when people lose their jobs, helping to cushion the impact of a recession. By maintaining a flow of income to the unemployed or those in financial distress, these payments support continued consumer spending. This, in turn, helps stabilize the economy by sustaining demand for goods and services during challenging times, preventing deeper recessions and accelerating recovery.

**Poverty Reduction:** One of the most direct impacts of transfer payments is their role in poverty reduction. Programs like cash transfers, food assistance, or housing support provide individuals and families with the financial resources they need to meet their basic needs. These payments help lift people out of poverty by ensuring they have a minimum level of income to cover essential expenses. Particularly in developing countries, direct transfers have proven to be an effective mechanism for reducing poverty and improving the living standards of the most disadvantaged populations.

In summary, transfer payments play an essential role in promoting social welfare by redistributing wealth, stabilizing the economy, and reducing poverty. Though they don't directly contribute to economic productivity, they are crucial for maintaining social stability and supporting those in need, ultimately contributing to a more equitable and resilient society.

## **Developmental Expenditure**

Developmental Expenditure refers to government spending aimed at fostering long-term socioeconomic improvements. This type of expenditure focuses on sectors such as healthcare, education, agriculture, and infrastructure, with the objective of improving the standard of living and boosting productivity. It also includes investments in research and development (R&D), skills training, and technological advancements, all of which contribute to the country's long-term development. Unlike revenue expenditure, which supports the functioning of existing

government programs, developmental expenditure aims to create the conditions for sustainable economic growth and improved quality of life.

### **Role of Developmental Expenditure:**

**Human Capital Development:** Developmental expenditure is critical for improving human capital, which is essential for driving economic progress. Government investments in education and healthcare play a vital role in enhancing the skills, health, and productivity of the population. Education equips individuals with the knowledge and skills required for various sectors, thereby improving workforce efficiency and innovation. Healthcare investments ensure a healthy workforce, reducing absenteeism and improving overall labor productivity. By enhancing human capital, developmental expenditure helps to lay the foundation for sustained economic growth and development.

**Technological Advancement:** Investment in research and development (R&D) is a key component of developmental expenditure, which drives technological advancement and innovation. R&D spending supports the development of new technologies, processes, and products that can enhance a country's economic competitiveness on a global scale. These advancements not only lead to increased productivity but also help in diversifying the economy and creating new industries. For instance, investments in renewable energy technology or information technology can position a country as a leader in emerging sectors, boosting economic growth and job creation.

**Rural and Agricultural Development:** For many developing countries, particularly those with large rural populations, developmental expenditure in agriculture and rural infrastructure is essential for improving food security and livelihoods. Investment in agricultural productivity through better irrigation systems, crop technologies, and rural infrastructure like roads and markets directly benefits small-scale farmers and rural communities. This type of spending helps reduce poverty in rural areas, provides employment opportunities, and ensures that food production is stable and sustainable. It also enhances rural development, improving living standards and economic opportunities in underserved regions.

In summary, developmental expenditure is a cornerstone of long-term economic and social progress. It focuses on building the foundations for human capital development, driving technological innovation, and supporting key sectors like agriculture and rural development. By making investments in these areas, governments can foster sustainable growth, reduce inequality, and improve the overall well-being of their citizens.

### **Non-Developmental Expenditure**

Non-developmental expenditure typically includes interest payments on government debt, defense spending, and general administrative expenses. These types of spending are fundamental for the functioning and stability of the state but do not directly lead to the creation of tangible economic assets or directly stimulate economic growth. Instead, they provide the necessary environment—such as security, governance, and financial stability—within which development can occur. In many developing and highly indebted countries, non-developmental expenditures occupy a significant share of the national budget, thereby reducing the fiscal space available for investments in sectors like education, health, and infrastructure. Among these, interest payments often represent the largest burden, particularly for nations struggling with high levels of public debt.

## **Role of Non-developmental Expenditure:**

**Debt Management:** Interest payments ensure that the government meets its financial obligations to both domestic and international creditors. By servicing its debt responsibly, the government preserves its credit rating and maintains access to capital markets at favorable borrowing terms. A default or delay in interest payments can severely damage a country's reputation, leading to higher interest rates on future borrowings or even exclusion from international credit markets. In extreme cases, it can trigger financial crises, currency devaluations, and widespread economic instability. Therefore, even though interest payments do not contribute directly to development, they are crucial for maintaining macroeconomic stability and trust in the government's financial management. However, a rising debt-servicing burden can lead to a situation where governments borrow more simply to pay off old debts, creating a vicious cycle known as a "debt trap," which can severely constrain developmental expenditure over time.

**Defense and Security:** Defense spending plays a critical role in safeguarding national sovereignty, protecting citizens, and maintaining internal law and order, all of which are prerequisites for sustained economic activity and investor confidence. A secure and stable environment enables businesses to operate, trade to flourish, and foreign investment to grow. However, when defense expenditure becomes disproportionately high compared to a country's total budget or GDP, it can result in the neglect of social sectors such as education, health, and infrastructure development. Excessive militarization can also foster regional arms races, further burdening public finances. Thus, while defense spending is non-negotiable for a nation's security, striking a balance is essential to ensure that it does not come at the cost of long-term developmental priorities. Optimal allocation to defense, based on actual threat assessments and strategic needs, allows more resources to be redirected toward sectors that directly improve human capital and productive capacity.

**Administrative Efficiency:** Non-developmental expenditure also encompasses the costs of running the government bureaucracy, including salaries, pensions, operational expenses, and maintenance of various administrative departments. An efficient administrative apparatus is vital for implementing policies, delivering public services, enforcing laws, and managing public resources effectively. However, inefficiencies such as overstaffing, outdated procedures, corruption, and redundant processes can lead to high administrative costs without corresponding improvements in governance quality. These inefficiencies not only waste public resources but also reduce public trust and satisfaction with government institutions. Therefore, it is essential for governments to undertake administrative reforms aimed at improving service delivery, reducing waste, modernizing systems (for example, through digitization), and ensuring accountability. By making administrative expenditures more efficient, governments can free up additional resources for developmental activities and ensure that public funds generate the maximum possible social and economic returns.

## **Social Expenditure**

Social expenditure refers to government spending aimed at promoting the welfare and well-being of its citizens. It includes investments in social protection systems, healthcare, education, housing, and various public services that support quality of life. The main goal of social expenditure is to ensure equitable access to basic needs and opportunities, irrespective of individuals' socio-economic backgrounds. This category of expenditure also covers funding for welfare programs that target vulnerable groups such as low-income families, the elderly, persons with disabilities, and marginalized communities. By investing in these areas,

governments seek to build an inclusive society where everyone has the chance to participate fully in economic, social, and political life. Furthermore, social expenditure is not merely about poverty alleviation; it is a strategic investment in building human capabilities and fostering sustainable development.

### **Role of Social Expenditure:**

**Reduction of Inequality:** One of the primary roles of social expenditure is to reduce income and opportunity inequality within a society. Social protection measures like unemployment benefits, pensions, child support, and disability allowances provide financial safety nets that protect individuals from the risks associated with income loss, illness, old age, or economic downturns. Public investments in education and healthcare ensure that even those from disadvantaged backgrounds have access to quality services, which levels the playing field and breaks the cycle of poverty. Without robust social spending, inequality tends to widen, leading to social unrest and undermining economic growth. Therefore, well-designed social expenditure policies are essential not only for justice and fairness but also for economic efficiency and social cohesion.

**Human Development:** Investments in education and healthcare are fundamental drivers of human development, which in turn is a critical factor for long-term economic growth. Spending on education improves literacy rates, skill levels, and innovation capacity, making the workforce more productive and adaptable to changing economic demands. Similarly, investment in healthcare leads to a healthier population, reduces absenteeism, and increases life expectancy—all of which contribute to higher economic output. Countries that have prioritized social investments, such as the Nordic nations, consistently rank high in both human development indices and economic competitiveness. By nurturing human capital through social expenditure, governments lay the foundation for sustained economic prosperity and improved quality of life for future generations.

**Social Stability:** Adequate social protection systems are crucial for maintaining social stability and public order. When people's basic needs are met, and when they feel secure against life's uncertainties, societies are generally more peaceful and cooperative. Social safety nets reduce the incidence of poverty, homelessness, and food insecurity, which are often root causes of crime, violence, and social unrest. By investing in social programs, governments can prevent marginalized populations from falling into desperation and conflict, thus promoting a more harmonious and stable society. Furthermore, public trust in government institutions is often stronger in countries where social expenditures are adequate and effectively managed, reinforcing the overall stability and functionality of the political system.

### **Economic Expenditure**

Economic expenditure refers to government spending specifically designed to enhance productivity, stimulate economic activity, and promote sustainable development across key sectors such as agriculture, industry, transport, energy, and communication. It covers a broad range of activities, including direct investments in critical infrastructure, subsidies to vital industries, and funding programs aimed at supporting entrepreneurship and innovation. Governments often deploy economic expenditure as a tool for implementing industrial policy, particularly in economies seeking diversification away from dependence on a few sectors. Strategic economic expenditure helps in building a strong economic base, improving competitiveness, creating jobs, and ensuring balanced regional development. By targeting key sectors through financial support, regulatory incentives, and infrastructure development, governments aim to stimulate private sector growth and raise overall economic performance.

## **Role of Economic Expenditure:**

**Boosting Productivity:** One of the central aims of economic expenditure is to boost national productivity levels. Investments in critical infrastructure such as energy grids, transportation networks (roads, railways, ports), and communication systems lower production and transaction costs for businesses. For example, better roads reduce shipping times and costs, while reliable electricity supply enhances manufacturing efficiency. Improvements in digital infrastructure enable faster and broader communication, essential for modern businesses. When businesses face fewer operational bottlenecks, they can scale up production, innovate more readily, and compete more effectively in domestic and international markets. Thus, strategic spending on infrastructure not only creates immediate employment opportunities but also lays the groundwork for long-term productivity gains across the economy.

**Sectoral Development:** Economic expenditure often focuses on nurturing specific sectors that are seen as vital for national development strategies. For instance, in developing countries, significant funds may be allocated to agriculture to ensure food security, increase rural incomes, and reduce poverty. In contrast, in developed economies, government support may concentrate on sectors like technology, green energy, or advanced manufacturing to maintain global competitiveness. Sector-specific investment fosters innovation, enhances the value chain, and accelerates sectoral transformation. By identifying priority sectors and supporting them through funding, training programs, research and development initiatives, and infrastructure, governments can drive sectoral growth, create specialized labor markets, and diversify the economy, making it more resilient to external shocks.

**Private Sector Leverage:** Well-targeted economic expenditure can also act as a catalyst for private sector investment. By reducing initial risks and providing necessary infrastructure, governments can create an environment that is attractive for private enterprises. Mechanisms such as public-private partnerships (PPPs) allow the government and private sector entities to collaborate on large-scale projects, especially in infrastructure like highways, airports, and power plants. When the public sector invests strategically, it signals confidence and stability to the private sector, encouraging further investment and innovation. Moreover, economic expenditure that supports small and medium-sized enterprises (SMEs) through credit facilities, training, and market access programs can significantly enhance entrepreneurial activity and job creation, leading to broader economic benefits.

## **Environmental Expenditure**

Governments around the world are placing increasing emphasis on environmental expenditure to address urgent challenges such as climate change, biodiversity loss, and pollution. This category of spending includes investments in renewable energy projects like solar, wind, and hydroelectric power; the development and expansion of waste management systems; water conservation programs; reforestation initiatives; and policies aimed at reducing carbon emissions. Environmental expenditure also covers funding for environmental research, public awareness campaigns, and the creation of regulatory frameworks that promote sustainable practices across industries. As global environmental crises escalate, strategic environmental spending has become essential for ensuring a sustainable future while simultaneously unlocking new economic opportunities in green industries.

## **Role of Environmental Expenditure:**

**Sustainable Development:** Environmental expenditure is crucial for ensuring that economic growth does not come at the expense of the environment. By promoting cleaner technologies,

enforcing pollution controls, and conserving natural resources, governments aim to harmonize economic advancement with ecological preservation. Sustainable development requires that today's growth does not compromise the ability of future generations to meet their own needs. Investments in green technologies, sustainable agriculture, and eco-friendly urban planning help reduce the ecological footprint of human activities and create a model of growth that respects planetary boundaries. Such expenditure ensures that natural ecosystems continue to provide essential services like clean air, water, and fertile soil, which are foundational to human and economic well-being.

**Climate Resilience:** Through investments in renewable energy, reforestation, sustainable agriculture, and infrastructure designed to withstand extreme weather events, governments can strengthen a nation's resilience to climate-related disasters. Environmental spending directed towards climate adaptation measures, such as the construction of flood defenses or drought-resistant farming techniques, reduces the vulnerability of communities and economies to climate risks. Enhancing resilience not only protects lives and livelihoods but also reduces the future economic burden associated with disaster response and recovery. By acting proactively, governments can mitigate the adverse effects of climate change and safeguard economic stability.

**Green Economy Transition:** Many governments are steering their economies toward a green transition, where growth is decoupled from carbon emissions and environmental degradation. Environmental expenditure supports the development of green industries, innovation in clean technologies, and the retraining of workers for jobs in sustainable sectors. Transitioning to a green economy also involves regulatory reforms, incentives for businesses to adopt eco-friendly practices, and investments in research and development. This shift promises not only to protect the environment but also to create new economic opportunities, boost competitiveness, and position countries advantageously in the emerging global green market.

## **Interest Payments**

Interest payments represent the cost of servicing a government's existing debt obligations. Governments must pay interest to bondholders and creditors on the money they have borrowed, whether for past development projects, budget deficits, or emergency financing. In highly indebted nations, interest payments can absorb a significant proportion of government revenues, leaving less room for discretionary spending on development, social services, or infrastructure. As debt levels rise, the challenge of managing interest payments becomes more pressing, influencing fiscal planning and national economic strategies.

### **Role of Interest Payments:**

**Fiscal Health:** High interest payments constrain a government's fiscal flexibility, making it harder to respond to new needs, emergencies, or investment opportunities. When a large share of revenue is tied up in debt servicing, there is limited scope for funding critical public services or launching new development initiatives. Persistent high interest obligations can increase the risk of fiscal crises, leading to austerity measures, loss of public trust, and potential defaults. Therefore, managing interest payments effectively is crucial to maintaining overall fiscal health, ensuring that a government remains capable of fulfilling its responsibilities without resorting to unsustainable borrowing practices.

**Debt Management:** Ensuring the timely payment of interest is vital for maintaining investor confidence in the government's financial management. A good repayment record helps secure better terms for future borrowing, such as lower interest rates and longer repayment periods.

Effective debt management includes strategic planning around borrowing, refinancing when interest rates are favorable, and limiting new debt accumulation. By managing its debt prudently, a government can maintain fiscal sustainability and ensure that debt remains a tool for development rather than a burden on future generations.

## **Defense Expenditure**

Defense expenditure encompasses the full range of government spending related to national defense and security. This includes military salaries and pensions, recruitment and training, procurement of weapons and military equipment, maintenance and modernization of defense infrastructure, and research and development for new defense technologies. Defense spending also covers operations both within a country's borders and in international peacekeeping or security missions. While defense is critical for protecting national interests and maintaining sovereignty, it represents a substantial portion of many national budgets and requires careful balancing against other social and developmental priorities.

### **Role of Defense Expenditure:**

**National Security:** Defense spending is fundamental to ensuring that a country can defend its borders, maintain internal stability, and respond effectively to external threats. A capable military acts as a deterrent against aggression, contributes to regional stability, and allows a country to play a role in international security initiatives. Investments in defense infrastructure and technology enhance a nation's strategic capabilities and protect critical national assets. Moreover, a secure environment is essential for economic development, foreign investment, and the uninterrupted functioning of civil society.

**Economic Considerations:** While necessary, excessive defense spending can divert valuable resources away from social programs, infrastructure development, and economic investments. High military budgets can strain public finances and reduce the funds available for education, healthcare, and poverty alleviation, which may in turn affect long-term social and economic outcomes. Balancing defense needs with the need for social welfare and economic development is a complex challenge for policymakers. Prudent defense spending involves strategic prioritization, avoiding waste, and ensuring that investments in defense contribute to national and global security without undermining broader developmental goals.

### **Factor Influencing Public Expenditure:**

Public expenditure is a key instrument through which governments influence economic growth, ensure social welfare, and maintain national security. However, the levels and patterns of such expenditure are not arbitrary — they are shaped by a complex interplay of economic, political, social, demographic, and financial factors. Understanding these influences provides critical insights into the dynamics of public finance and policy-making.

### **Economic Growth and Development**

**Impact:** The overall performance of the economy fundamentally determines government revenues and expenditures. During periods of robust economic growth, individuals and businesses generate more income and profits, leading to higher tax collections (income tax, corporate tax, VAT, etc.). With greater financial resources, governments are able to undertake expansive spending programs — building infrastructure (roads, bridges, ports), investing in human capital (schools, hospitals), and providing social security benefits.

In contrast, during periods of economic recession or stagnation, tax revenues decline. To manage fiscal deficits, governments may be forced to cut spending, prioritize urgent needs, or

borrow more, which can result in debt accumulation. Some governments may pursue expansionary fiscal policies — increasing public expenditure even during downturns — to stimulate demand, restore business confidence, and reduce unemployment.

**Example:** After the 2008 global financial crisis, many countries adopted fiscal stimulus programs (e.g., the U.S. American Recovery and Reinvestment Act) involving massive public spending to counteract recession.

**Cyclical:** Public expenditure is often countercyclical: it rises during economic downturns to support demand and falls during economic booms to prevent overheating. Developing countries, especially those undergoing structural transformation, often experience pro-cyclical expenditure patterns, ramping up spending during economic expansions to finance much-needed investments in infrastructure, education, healthcare, and industry.

**Example:** China's rapid economic development was accompanied by massive government-led investments in roads, railways, and urban infrastructure during its high-growth periods.

### **Government Ideology**

**Impact:** The political ideology and priorities of the ruling government heavily influence where and how much money is spent. A government that emphasizes social justice and equality may allocate more to social welfare programs (healthcare, unemployment insurance, housing). Conversely, a government prioritizing market liberalization and private sector growth may reduce public spending, deregulate industries, and emphasize fiscal austerity.

**Example:** Scandinavian countries such as Sweden and Denmark, under social-democratic governments, have historically maintained high public expenditure levels to fund comprehensive welfare programs.

**Policy Goals:** Public expenditure is closely aligned with specific policy goals set by the government. For instance, a government focused on industrialization may allocate significant budgets to developing special economic zones, providing subsidies to industries, and funding technological innovation. Another government may prioritize green energy, channeling public resources into solar and wind energy projects.

**Example:** India's focus on renewable energy through initiatives like the National Solar Mission reflects a clear policy goal influencing the direction of public expenditure.

**Welfare State:** In welfare states, public expenditure is viewed as a mechanism for redistributing wealth and ensuring that every citizen has access to basic goods and services. Such models prioritize social justice and economic security over purely market-driven outcomes.

**Example:** Norway's government heavily funds universal healthcare, free higher education, and pension systems through public expenditure supported by oil revenues.

### **Demographic Changes**

**Impact:** Demographics — the age, size, and distribution of a country's population — significantly impact public expenditure needs. As demographic patterns shift, governments must adapt spending to address emerging demands.

**Example:** Rapid population growth in sub-Saharan Africa necessitates greater investments in education, job creation, and basic health services.



**Aging Population:** An aging population results in increased demand for healthcare services (e.g., elderly care, geriatric hospitals), pension payments, and social security programs. Governments must allocate a larger share of their budgets to meet these obligations, putting pressure on working-age taxpayers.

**Example:** Japan, where over 28% of the population is aged 65 or older, spends a significant portion of its public budget on healthcare and pensions.

**Urbanization:** As more people move to urban areas, governments face new challenges, including traffic congestion, slum development, pressure on water and sanitation systems, and the need for affordable housing. Urban development projects, public transportation systems, and social services expansion become major areas of public expenditure.

**Example:** In China, rapid urbanization led the government to spend heavily on metro systems, new cities, and infrastructure to accommodate the urban influx.

### **Inflation**

**Impact:** Inflation — the general increase in prices — erodes purchasing power, affecting not just households but also government budgets. As the cost of inputs for public projects rises (e.g., materials, labor), governments must either increase allocations or reduce the scale of projects.

Inflation can also increase the demand for public sector wage adjustments, social welfare indexation, and subsidies to shield vulnerable groups from rising living costs.

**Example:** High inflation rates in Argentina have forced continuous adjustments in social transfer payments to maintain their real value.

**Interest Rates:** Higher interest rates raise the cost of government borrowing, as newly issued bonds must offer higher yields to attract investors. This means that governments will spend more on interest payments, crowding out spending in critical sectors such as education, defense, or social security.

**Example:** In many African countries, high-interest external debt servicing has consumed over 30% of public revenues, constraining investments in health and infrastructure.

### **Fiscal Policy and Taxation**

**Impact:** Fiscal policy decisions determine how much a government chooses to tax and spend. A government pursuing aggressive public investment strategies may increase taxes or resort to deficit financing, while another aiming for a leaner state may cut taxes and limit public programs.

**Example:** The New Deal in the U.S. during the 1930s greatly expanded public expenditure to combat the Great Depression through public works and social programs.

**Budget Deficits and Surpluses:** Governments running budget deficits often increase borrowing to finance current or capital expenditures. Persistent deficits can lead to rising debt levels and interest burdens. Conversely, budget surpluses provide fiscal space to either increase spending, invest in infrastructure, build sovereign wealth funds, or reduce debt.

**Example:** Norway invests its oil revenue surpluses into the Government Pension Fund Global, the world's largest sovereign wealth fund, ensuring future fiscal stability.

**Tax Revenues:** High and stable tax revenues provide governments with a reliable source of funding for consistent public service delivery. However, excessive taxation can reduce

economic incentives and distort market behavior, while tax cuts may lead to deficits unless offset by expenditure cuts.

**Example:** The Nordic model relies on relatively high taxation levels (including VAT and income taxes) to fund comprehensive public services.

### **Debt Levels and Public Debt Servicing**

**Impact:** High public debt places a significant burden on government budgets. Debt servicing (i.e., paying the interest and principal on existing debt) is often a priority for governments, which can severely limit their ability to allocate funds for essential public services such as education, healthcare, and infrastructure.

**Example:** Greece faced a sovereign debt crisis in the early 2010s, where high debt levels led to severe austerity measures. The country's debt-to-GDP ratio was unsustainable, requiring the government to divert funds from social welfare and public services to meet debt obligations.

**Crowding Out:** When governments prioritize debt repayment, other important sectors—such as infrastructure development or social services—may suffer. This is referred to as the "crowding out" effect, where essential services are underfunded to make room for debt servicing.

**Example:** Italy has faced challenges in balancing debt repayments with the need for investment in public services. As a result, healthcare and education sectors have seen reduced budgets, despite their importance to the economy.

**Debt Management Strategies:** Governments may adopt a variety of strategies to manage high debt levels:

**Austerity measures:** These may involve cuts in public spending to reduce fiscal deficits and manage debt more effectively.

**Growth-oriented borrowing:** Governments may borrow more to invest in projects that are expected to spur economic growth, thereby increasing future revenues and reducing the debt-to-GDP ratio.

**Debt restructuring or renegotiation:** In some cases, countries may negotiate with creditors to restructure or defer debt repayments.

**Example:** Argentina has repeatedly negotiated debt restructuring with creditors, including a major restructuring in 2020 that reduced the burden of foreign debt and allowed the country to stabilize its public finances.

### **Defense and National Security**

**Impact:** Geopolitical factors such as external threats, conflicts, or military obligations directly influence public expenditure, especially in countries facing security concerns. National defense is often one of the largest areas of government spending in countries with military obligations or regional tensions.

**Example:** Israel allocates a significant portion of its budget to defense spending, as the country faces constant security threats in a volatile region. As a result, defense spending accounts for over 5% of its GDP, influencing other budget allocations.

**Defense Spending:** Even during peacetime, countries may prioritize defense spending for military modernization, technological advancements (e.g., drones, cyber defense), and fulfilling international defense commitments (e.g., NATO obligations).

**Example:** The United States continues to spend large sums on defense even during non-conflict years, primarily due to its strategic global commitments and military modernization programs (e.g., F-35 fighter jets, nuclear submarine fleets).

High defense spending can divert funds from social or developmental expenditure, impacting welfare programs or infrastructure development.

### **Technological Advancements**

**Impact:** Technological progress shapes public expenditure by creating new demands for digital infrastructure, cybersecurity measures, and research and development (R&D) investments. Governments must allocate funds to ensure they remain competitive in the global digital economy and safeguard national security.

**Example:** Estonia has invested heavily in digital government infrastructure, providing e-government services and establishing digital identities for citizens. This investment has enhanced efficiency in public service delivery but requires ongoing financial commitment to maintain and upgrade technology.

**Efficiency Gains:** While technology can lead to increased expenditure in the short term, it can also reduce costs in the long run by improving the efficiency of government operations. Digital platforms can streamline administrative processes, reduce paperwork, and enhance public service delivery.

**Example:** The implementation of e-government in countries like South Korea has significantly reduced the cost of bureaucratic processes, improving service delivery and reducing administrative overhead for both the government and citizens.

**R&D and Innovation:** Governments must also invest in innovation and research to stay ahead in fields such as artificial intelligence (AI), quantum computing, and biotechnology.

**Example:** China has made substantial investments in AI, with government-backed initiatives aimed at establishing the country as a global leader in artificial intelligence by 2030.

### **Globalization and International Commitments**

**Impact:** Globalization connects countries economically, politically, and culturally. This interconnectedness often forces governments to adapt their fiscal policies to global trends, including trade agreements, regulatory compliance, and international cooperation on issues like climate change and public health.

**Example:** The European Union (EU) has required member states to comply with specific budgetary rules (e.g., deficit limits) and environmental regulations, shaping public expenditure in member countries like Germany, France, and Italy.

**International Obligations:** Membership in international organizations often brings with it financial obligations. These obligations can influence national budgets as countries contribute to global initiatives or adhere to international standards.

**Example:** As a member of the United Nations (UN), Japan contributes significant funds to UN peacekeeping missions, humanitarian aid, and development projects in developing countries.

**Global Economic Conditions:** The interconnectedness of the global economy means that conditions in other countries—such as economic recessions or booms—can impact domestic revenue generation and spending priorities.

**Example:** The 2008 global financial crisis caused widespread reductions in revenue and increased public expenditure on stimulus programs across many countries, as governments intervened to stabilize economies.

### **Natural Disasters and Climate Change**

**Impact:** Natural disasters require governments to immediately allocate funds for emergency relief, reconstruction, and long-term disaster preparedness. As climate change intensifies the frequency and severity of natural disasters, governments must increasingly divert resources to address environmental challenges.

**Example:** The 2011 earthquake and tsunami in Japan led to immediate government spending on disaster relief and long-term reconstruction, as well as adjustments to future disaster preparedness programs.

**Environmental Spending:** Governments are now allocating increasing portions of their budgets to mitigate and adapt to climate change. This includes investments in renewable energy, carbon emission reductions, and infrastructure designed to withstand extreme weather events.

**Example:** The Netherlands has made significant investments in flood protection systems to adapt to rising sea levels and is a global leader in water management technology.

**Climate Change Adaptation:** Countries must spend to adapt their infrastructure, economy, and population to the impacts of climate change, from flooding to drought. These adaptation measures require significant long-term financial commitment.

**Example:** Bangladesh has invested heavily in flood defense infrastructure due to its vulnerability to climate change. The government has also focused on agricultural reforms to help farmers adapt to changing climate patterns.

### **Social and Cultural Factors**

**Impact:** Societal expectations and cultural values also shape public expenditure. In countries with strong social welfare traditions (e.g., Nordic countries), there is generally greater public pressure to maintain high levels of spending on health, education, and welfare.

**Social Movements:** Public demand for social justice, gender equality, or poverty alleviation can influence expenditure decisions. For example, social movements calling for expanded access to healthcare or education can push governments to increase funding for these sectors.

### **Corruption and Governance Quality**

**Impact:** Governance quality has a profound effect on the efficiency and effectiveness of public expenditure. Corruption, inefficiency, and bureaucratic red tape can inflate public spending or divert funds away from intended projects.

**Leakage of Funds:** In countries with high levels of corruption, a significant portion of public expenditure may be lost to inefficiencies or fraud, reducing the amount available for productive uses.

**Public Financial Management:** Strong institutions, accountability, and transparency in public financial management can improve the allocation and utilization of government resources.

### **Health Crises and Pandemics**

**Impact:** Health crises such as pandemics (e.g., COVID19) can result in sudden and significant increases in public expenditure. Governments may need to allocate resources for healthcare infrastructure, medical supplies, research, and income support for affected citizens.

**Public Health Infrastructure:** Investing in healthcare infrastructure, disease prevention, and vaccination programs becomes a priority during health emergencies, reshaping budget priorities.

Public expenditure is shaped by a complex interplay of economic, political, social, demographic, and external factors. Governments must constantly adapt their spending patterns to respond to changing economic conditions, social needs, and external pressures. The challenge lies in striking a balance between short term needs and long term fiscal sustainability, ensuring that public expenditure promotes both economic growth and social welfare while maintaining financial stability.

## **Lesson- 2: Theories, Related to Public Expenditure and Factors Influencing Public Services**

### **Lesson Objectives**

After completing the lesson, you will be able to:

- Apply demand theories to explain rising public expectations for government services and how they drive spending.
- Examine supply side factors, such as technological changes, that impact the cost and scope of public expenditure.
- Assess the relationship between the economic climate and the quality and provision of public services.
- Understand how governments adjust public services during periods of economic growth or contraction.

### **Demand and Supply Theories to Explain the Trends in Public Expenditure**

Theories of demand and supply in public finance provide insights into the trends and dynamics of public expenditure over time. These theories explain how various factors drive both the demand for government services (and thus public spending) and the government's ability to supply these services (through revenue generation). Below is an analysis of how demand and supply theories explain the trends in public expenditure:

#### **Wagner's Law (Law of Increasing State Activity)**

**Overview:** Wagner's Law, proposed by German economist Adolph Wagner in the late 19th century, suggests that as an economy grows, the level of public expenditure increases both absolutely and as a percentage of GDP. In essence, Wagner posited that economic growth leads to an expansion in the role and size of the state.

#### **Key Aspects of Wagner's Law:**

**Demand Perspective:** Economic Growth and Public Service Demand: As an economy grows, income levels rise, leading to an increase in the demand for public services. This demand primarily comes from sectors like education, healthcare, infrastructure development, and welfare programs.

For example, as economies like China or India urbanize, there's greater demand for better public healthcare systems, education, and other social services, which requires governments to increase spending.

**Urbanization and Industrialization:** With economic development comes urbanization, industrialization, and modernization. These processes increase the complexity of the economy, which in turn demands more regulatory oversight, public goods (like roads, utilities), and social services.

Example: The rise of smart cities and public transportation systems in highly industrialized countries reflects the growing demands for government services as economies expand.

**Higher Standards of Living:** As the standard of living improves, people expect higher-quality public services. This creates pressure on governments to meet these expectations, pushing up public expenditure.

**Example:** In Nordic countries like Sweden, high income levels result in widespread demand for comprehensive social welfare programs (healthcare, pensions, etc.), leading to higher government spending.

### **Supply Perspective:**

**Government Revenue Capacity:** With economic growth, governments typically experience an increase in tax revenue and other revenue sources. This enhanced revenue capacity gives governments the ability to increase their spending to meet the growing demand for public services.

Example: Germany's robust economy allows the government to fund social welfare programs and infrastructure development, partially due to strong tax revenue from its thriving industrial sector.

**Expanded Government Role:** As a country's economy matures, the government's role in regulating and providing for infrastructure, social welfare, and cultural institutions becomes more prominent.

For instance, in Canada, the government has expanded its role to include programs like universal healthcare and education subsidies, reflecting a broader government footprint in citizens' lives as the economy grows.

**Explanation of Trends:** Historically, countries have experienced rising public expenditure in response to their growing economies, which supports Wagner's hypothesis. As countries become wealthier, the government typically takes on a larger role, expanding its responsibilities in a variety of domains such as:

**Public Goods:** Governments provide essential goods that are non-excludable and non-rivalrous (e.g., national defense, clean air).

**Social Security:** With higher levels of wealth, there's greater demand for social security, pensions, and other safety nets.

**Infrastructure Development:** Economic development leads to greater demands for roads, public transportation, energy grids, etc., which are funded by the government.

**Example:** The United States saw a rise in public expenditure throughout the 20th century, particularly during periods of significant economic growth (e.g., post-WWII economic boom). As the U.S. economy grew, the government increased spending on social security, infrastructure (like highways), and other services to accommodate its expanding population and industrial growth.

### **Real-World Examples Supporting Wagner's Law:**

**Post-WWII Growth in Europe:** After World War II, countries like France and Germany experienced rapid economic growth. With this growth, both public demand for services and the government's ability to fund those services through taxation increased. For example, France expanded its public health system, social services, and national infrastructure following the war, supporting Wagner's Law.

**East Asian Tigers (Hong Kong, Singapore, South Korea, Taiwan):** These economies rapidly industrialized in the second half of the 20th century. The governments in these nations

increased their public spending significantly on infrastructure (e.g., transportation networks, energy), public services (e.g., education, healthcare), and development programs to keep up with the expanding urban and industrial needs. The rapid rise in public expenditure accompanied by economic growth validates Wagner's hypothesis.

### **Criticisms of Wagner's Law:**

While Wagner's Law provides a useful framework, there are criticisms and limitations to its broad application:

**Empirical Discrepancies:** Some countries have not followed Wagner's predictions. For instance, in some developing countries, economic growth hasn't always resulted in higher government expenditure. This can be due to issues like poor governance, inefficiency, or external debt constraints.

**Technological Impact:** In modern economies, advances in technology and digital infrastructure have altered the pattern of public expenditure, potentially reducing the need for state involvement in some sectors. E-government and automation may reduce public administration costs, challenging Wagner's assumption that government expenditure grows continuously with economic growth.

Wagner's Law offers valuable insights into the relationship between economic growth and public expenditure. As countries grow wealthier, there is a natural increase in demand for government-provided services, and governments can afford to increase spending due to higher revenues. However, the extent of this expansion can be influenced by factors like government efficiency, technological advancements, and economic policy choices. While Wagner's Law holds generally true in many contexts, it is not a universal principle and can vary depending on local conditions.

### **Peacock Wiseman Hypothesis (Displacement Effect)**

**Overview:** The Peacock-Wiseman Hypothesis, proposed by economists Alan Peacock and Jack Wiseman in 1961, argues that public expenditure tends to increase in spurts, often triggered by crises such as wars, economic recessions, or natural disasters. These crises create a surge in demand for government intervention, and after the crisis subsides, the higher levels of spending become normalized and permanent.

The key idea is that, after a crisis, what was once seen as temporary, emergency spending becomes institutionalized, leading to a long-term increase in government expenditure. This process is referred to as the Displacement Effect—the idea that an increase in government spending during a crisis displaces the previous spending pattern, often leading to permanent, higher levels of expenditure.

### **Key Aspects of the Peacock-Wiseman Hypothesis:**

#### **Demand Perspective:**

**Crisis-Induced Surge in Public Demand:** During crises, governments face increased demand for intervention across multiple sectors. For example:

**Wars:** The need for military spending and defense increases drastically.

**Economic Recessions:** Unemployment benefits, social welfare programs, and stimulus measures to revive the economy are heavily required.

**Natural Disasters:** Governments need to invest in emergency relief, infrastructure rebuilding, and disaster management.



**Pandemics (e.g., COVID-19):** Governments need to allocate significant resources to healthcare systems, income support programs, and recovery measures.

After the crisis, there is often a lasting public demand for these services to be maintained, even after the immediate need has passed. As a result, the government maintains these higher levels of expenditure, which were once viewed as extraordinary.

### **Supply Perspective:**

**Increased Revenue Through Taxation and Borrowing:** In response to the increased demand for government services during a crisis, governments typically increase taxation or borrow more to finance the surge in public spending.

**Normalization of High Taxation:** After a crisis, the higher levels of taxation or public borrowing often become normalized in society. People may accept the higher tax rates, and governments find it easier to maintain these levels of revenue. This enables the government to continue spending at the new higher levels even after the crisis has ended.

For example, after World War II, many governments in Europe maintained higher levels of taxation and public spending for reconstruction and welfare programs, as the public accepted the higher expenditure in the wake of the war.

### **Explanation of Trends:**

Historically, major events such as the Great Depression, World Wars, and more recently, the COVID-19 pandemic have resulted in sudden spikes in government expenditure. These crises pushed governments to introduce new spending programs, such as unemployment benefits, national defense, public health spending, and stimulus packages.

After these crises, public expenditure typically does not revert to pre-crisis levels. Instead, the government continues to spend at the higher level that was deemed necessary during the crisis, leading to an upward trend in government spending over time.

**Example 1: The Great Depression (1930s):** In response to the economic downturn, governments introduced major relief programs like Social Security in the United States and welfare state initiatives in Europe. These programs, initially set up as temporary responses to the depression, eventually became permanent features of government spending and have continued to grow over time.

**Example 2: World War II:** The war required massive defense spending, and after the war, many governments, particularly in Europe, continued to allocate significant resources to rebuild their economies and provide social welfare programs. These wartime expenditures, although reduced, became institutionalized, and defense spending remained high in many countries even in peacetime.

**Example 3: COVID-19 Pandemic:** In response to the global health crisis, governments around the world introduced large-scale fiscal stimulus packages, unemployment benefits, healthcare spending, and reconstruction efforts. After the crisis, many of these new levels of spending were retained as governments maintained expanded social programs, highlighting how the crisis-induced expenditures were institutionalized.

### **Real-World Examples Supporting the Peacock-Wiseman Hypothesis:**

**The UK After World War II:** Following World War II, the UK government significantly increased its spending on healthcare (leading to the creation of the National Health Service, NHS), social welfare, and infrastructure rebuilding. These expenditures, initially seen as wartime necessities, became part of the permanent government budget, with social programs expanding over the subsequent decades.

**The United States After the Great Depression:** The New Deal programs introduced by President Franklin D. Roosevelt during the Great Depression included major expansions in social security, public works, and unemployment insurance. These programs were initially temporary measures but eventually became permanent features of U.S. public expenditure, with increased government involvement in the welfare state.

**Post-2008 Financial Crisis:** The global financial crisis of 2008 led to a surge in public expenditure for bank bailouts, stimulus packages, and economic recovery programs. Governments globally, especially in developed countries, increased spending to support their economies, and although the immediate crisis passed, many of these programs and the higher levels of public expenditure continued, resulting in a permanent increase in government spending.

**COVID-19 Pandemic:** The pandemic saw countries around the world increase their spending on healthcare, vaccines, unemployment benefits, and economic stimulus packages. These emergency expenditures were rapidly scaled up and became normalized, with some governments continuing or even expanding these measures beyond the immediate crisis to support economic recovery.

### **Criticisms of the Peacock-Wiseman Hypothesis:**

**Lack of Uniformity Across Crises:** While the hypothesis suggests a permanent increase in government expenditure, the extent to which this happens can vary across different crises and governments. For example, some crises may lead to temporary increases in expenditure that are later scaled back, or governments may fail to maintain higher spending even if public demand remains.

**Political and Ideological Factors:** The degree to which government expenditure remains elevated post-crisis can be influenced by the political climate. Governments with austerity-oriented policies, for example, may actively cut back on spending after a crisis, contrary to the Peacock-Wiseman Hypothesis.

The Peacock-Wiseman Hypothesis offers an insightful perspective on how crises can lead to permanent shifts in government expenditure patterns. Crises such as wars, recessions, and pandemics create temporary surges in demand for government intervention, and once these higher levels of spending are normalized, they tend to become institutionalized, leading to long-term increases in public expenditure. This theory highlights the displacement effect where extraordinary expenditures during crises shift to become the new norm, reshaping the trajectory of government spending in the long run.

### **Musgrave's Theory of Public Expenditure Growth**

**Overview:** Richard Musgrave's Theory of Public Expenditure Growth, proposed in the mid-20th century, divides public expenditure into three fundamental functions:

**Allocation:** The provision of public goods and services that the market cannot supply efficiently (e.g., national defense, law enforcement, public infrastructure).

**Distribution:** Redistribution of income and wealth to promote greater equity within society (e.g., social security, unemployment benefits, progressive taxation).

**Stabilization:** The use of fiscal policy (spending and taxation) to stabilize the economy, addressing issues like unemployment, inflation, and economic recessions.

Musgrave's theory highlights the increasing role of governments in these three areas as societies grow more complex, leading to an increase in public expenditure. His model shows how the demand for public services and redistribution rises as economies expand, and how governments play a crucial role in maintaining social welfare and economic stability.

### **Key Aspects of Musgrave's Theory:**

#### **Demand Perspective:**

**Economic Growth and Public Goods:** As economies grow and societies become wealthier, the demand for public goods increases. Public goods are non-excludable and non-rivalrous, meaning they are available for everyone and one person's consumption does not reduce availability for others. Examples include:

**National Defense:** As the complexity of society increases, so does the need for defense and law enforcement.

**Public Health:** As people's living standards improve, demand rises for public health systems that prevent disease, provide healthcare, and manage pandemics.

**Infrastructure:** Economic growth often requires improvements in roads, transportation, energy, and communication infrastructure.

**Education:** The growing value placed on an educated workforce increases demand for public education services, both in terms of quality and accessibility.

**Merit Goods:** Merit goods are those that provide benefits to individuals and society that may not be fully appreciated by the individual (e.g., education, healthcare). As societies become wealthier, there is a greater demand for these services:

**Education and Healthcare:** As incomes rise, there is a public demand for higher-quality education and healthcare systems, leading to increased expenditure in these areas.

**Redistribution Policies:** Growing income inequality, coupled with societal expectations for equity, drives the demand for policies that redistribute wealth. As economies grow and income disparities widen, citizens demand more from the government in terms of social safety nets:

**Social Security:** Governments expand social insurance programs like pensions, disability insurance, and unemployment benefits to reduce poverty and inequality.

**Progressive Taxation:** There is also demand for taxation systems that ensure higher-income individuals contribute proportionally more, enabling the government to fund these redistributive policies.

#### **Supply Perspective:**

**Economic Growth and Government's Capacity:** As the economy grows, so does the government's capacity to generate revenue through taxes and other sources. Governments can raise more revenue to fund public expenditure, which enhances their ability to provide public goods, services, and income redistribution.

**Revenue Generation:** The expansion of the economy means higher incomes and greater corporate profits, which boosts tax revenues, allowing governments to fund larger social programs.

**Capacity for Fiscal Intervention:** With a stronger economic base, governments can also enact policies that provide economic stabilization, such as increased public investment or emergency spending during recessions.

**Government's Role in Economic Stabilization:** Governments also use fiscal tools (taxation and public spending) to stabilize the economy. These tools help manage fluctuations in the business cycle:

Governments increase public spending or adjust taxes to manage economic downturns and prevent excessive inflation during booms. For example, during a recession, the government may increase public expenditure to stimulate demand (e.g., infrastructure projects, unemployment benefits), and during periods of inflation, it may cut spending or raise taxes.

**Social Services Expansion:** As the economy grows, the role of the government expands, and public spending increasingly focuses on the provision of public services (e.g., health, education, social welfare). Governments' expanded fiscal capacity allows them to invest in these areas more substantially.

### **Explanation of Trends:**

**Resource Allocation:** Over time, the role of government has shifted from simply ensuring basic infrastructure and public order to actively participating in resource allocation, including large-scale provision of public goods and services (e.g., national defense, public education, healthcare).

**Income Redistribution:** As economic development progresses, societies increasingly demand policies aimed at redistributing wealth. Musgrave argues that public expenditure growth is partly driven by efforts to reduce income inequality and provide a more equitable distribution of wealth.

**Macroeconomic Stabilization:** The need for economic stabilization increases as economies grow. Governments must intervene in times of economic instability to manage inflation, unemployment, and economic growth, further increasing public expenditure.

**Welfare State Model:** As economies advance, particularly in Western Europe and North America, many nations have adopted the welfare state model. This model involves significant government intervention in areas such as healthcare, education, unemployment insurance, and pensions, resulting in a substantial increase in public expenditure. The welfare state has become one of the defining features of many modern economies.

### **Historical Examples:**

- In post-World War II Europe, many governments expanded their role in economic and social affairs, providing extensive social security systems, healthcare, and educational opportunities. The UK's creation of the National Health Service (NHS) and the extension of social security benefits are key examples of this trend.
- In the United States, the New Deal policies introduced by President Franklin D. Roosevelt during the Great Depression represented an expansion of the government's role in economic stabilization and redistribution. These policies established long-term programs such as Social Security and unemployment insurance that have continued to shape the country's welfare system.

Musgrave's theory underscores the dynamic relationship between economic growth and the increasing demand for public goods, services, and redistribution policies. As societies grow

wealthier and more complex, governments increasingly take on responsibilities related to resource allocation, income redistribution, and macroeconomic stabilization, leading to higher levels of public expenditure. The expansion of these functions, particularly in the context of the welfare state, has been a key driver of government spending growth in developed economies. As economies continue to develop, the role of governments in providing for public welfare, equity, and economic stability will likely continue to grow, reflecting Musgrave's enduring theory.

### **Baumol's Cost Disease**

**Overview:** Baumol's Cost Disease is an economic phenomenon that explains why labor-intensive sectors—particularly those involving public services—tend to experience rising costs over time at a rate that outpaces productivity growth. Named after economist William J. Baumol, the theory suggests that in sectors like healthcare, education, and law enforcement, the costs of providing services increase faster than in sectors such as manufacturing or technology due to the relatively low gains in productivity in these labor-intensive industries.

Baumol's cost disease is crucial for understanding the long-term growth of public expenditure in economies, especially in areas like education and healthcare, where the public sector plays a prominent role. It highlights the structural challenges governments face in maintaining quality public services in the face of rising costs.

### **Key Aspects of Baumol's Cost Disease:**

#### **Demand Perspective:**

**Labor-Intensive Nature of Public Services:** Many public services—such as education, healthcare, and law enforcement—are inherently labor-intensive. These services rely on human labor to provide care, instruction, and security, and they are limited by technological advances in terms of productivity improvement.

- Despite the increasing use of technology in these sectors (such as online learning or telemedicine), the fundamental tasks still require a significant amount of human interaction and expertise. Teachers, doctors, nurses, and social workers are integral to delivering these services, and automation cannot easily replace them.

**Rising Demand for Public Services:** As societies grow and become more affluent, the demand for quality public services generally increases. This increase is driven by:

**Population Growth:** More people require education, healthcare, and law enforcement services.

**Higher Expectations:** As people's incomes rise, their expectations for better public services also grow. Society demands higher quality education, better healthcare, and more accessible public safety, which often requires expanding services.

**Demographic Changes:** Aging populations in many countries increase the demand for healthcare services, as older individuals require more medical attention.

**Limited Productivity Gains in Service Sectors:** While sectors like technology and manufacturing benefit from productivity-enhancing innovations (e.g., automation, software improvements), labor-intensive public services don't experience similar gains.

For instance, teaching a class or treating a patient doesn't become much faster or more efficient simply due to technological progress.

In contrast, industries like manufacturing benefit from improvements in automation, machine efficiency, and economies of scale, which lead to lower per-unit costs over time.

### **Supply Perspective:**

**Wages in the Public Sector:** To attract skilled workers in labor-intensive sectors such as education or healthcare, governments must offer wages that are competitive with the private sector.

If the public sector does not match or offer comparable wages to the private sector, it risks losing qualified workers to private companies. This creates upward pressure on wages in public services.

While private sector wages may rise due to increased productivity, wages in the public sector have to rise simply to retain and attract qualified workers, even if productivity does not increase at the same rate.

**Rising Costs Without Corresponding Productivity Gains:** Since public services do not see productivity improvements equivalent to those in other sectors (such as manufacturing or IT), governments must spend more money to deliver the same level of service. This creates higher per-unit costs over time.

Wage inflation in the public sector further exacerbates this problem. Even if the number of workers in these sectors remains stable, the rising wages of teachers, healthcare workers, and police officers can lead to higher overall expenditure without improvements in service output.

### **Explanation of Trends:**

**Disproportionate Rise in Costs:** Baumol's cost disease helps explain why public expenditure on education, healthcare, and other services has increased disproportionately over time. These sectors often face rising costs even in the absence of improvements in productivity. While technological advances may help reduce costs in certain areas, such as administrative tasks in healthcare or digitizing educational content, the core functions of these sectors still rely on human labor and are relatively immune to large-scale productivity improvements.

### **Historical Trends in Public Spending:**

**Healthcare:** The healthcare sector is a prime example of Baumol's cost disease. Despite the advent of medical technology that has improved the quality of care (e.g., better diagnostic tools, robotic surgeries), the cost of healthcare continues to rise. As the population ages and the demand for healthcare services increases, governments must allocate more resources to meet these demands. However, without significant productivity gains (aside from administrative efficiencies), the cost of healthcare services continues to outpace general economic growth.

**Education:** In the education sector, while online learning platforms have emerged, the core of education remains fundamentally labor-intensive. Teachers, counselors, and administrators are still needed to interact with students and ensure educational quality. Consequently, public spending on education has continued to grow, especially in countries investing in public education to ensure that all citizens have access to quality education.

**Public Safety and Law Enforcement:** Law enforcement, while benefiting from some technological tools (e.g., surveillance systems, automated processing of data), still requires a substantial human workforce. As society becomes more complex and urbanized, the demand for police and public safety services rises, leading to higher public expenditure.

## **Impact on Long-Term Public Expenditure Trends:**

**Sustained Growth in Public Spending:** Baumol's cost disease suggests that public spending in labor-intensive sectors like education and healthcare will continue to grow at rates faster than overall economic growth, leading to long-term upward pressure on public expenditure.

**Challenges for Governments:** Governments must balance the demand for high-quality public services with the need to manage costs. As the cost of providing these services rises due to wage inflation and the lack of significant productivity gains, governments are faced with difficult choices:

**Increasing Taxes:** To fund rising costs, governments may need to raise taxes, particularly in economies that prioritize public sector services.

**Reallocation of Funds:** Governments may also reallocate funds from other areas or cut costs in other parts of the public sector to finance rising spending in healthcare and education.

**Efficiency Improvements:** Governments may attempt to find cost-saving innovations in areas like administrative procedures, procurement, and delivery mechanisms, but these improvements may not fully offset the underlying structural cost increases due to Baumol's cost disease.

Baumol's Cost Disease provides an insightful explanation of the long-term increase in public expenditure in sectors such as healthcare, education, and law enforcement. It highlights the challenges faced by governments as they strive to meet the growing demand for quality public services while dealing with rising labor costs and limited productivity improvements in these sectors. The ongoing rise in public spending, driven by the cost disease, requires policymakers to find creative solutions to manage costs while ensuring that citizens continue to receive the services they need.

## **Public Choice Theory**

**Overview:** Public Choice Theory applies economic principles to political decision-making, treating voters, politicians, and bureaucrats as rational individuals who make decisions based on self-interest. This theory, developed by economists such as James Buchanan and Gordon Tullock, argues that public expenditure tends to increase because these groups have incentives to expand government spending in ways that benefit them, often at the expense of broader societal welfare.

## **Key Concepts of Public Choice Theory:**

### **Self-Interest of Politicians:**

**Political Incentives:** Politicians seek to maximize their chances of reelection by catering to voters' preferences. To achieve this, they may advocate for increased government spending on popular programs or services that benefit certain constituencies.

For instance, voters in certain regions or industries may demand subsidies, welfare programs, or infrastructure projects. Politicians respond by increasing spending on these items to garner voter support and secure their re-election.

**Short-Term Focus:** Politicians are often focused on short-term goals (like getting re-elected) rather than long-term fiscal sustainability. Thus, they may prefer spending that yields immediate benefits to their electorate, even if these expenditures contribute to long-term budget deficits.

### **Voters and Rational Ignorance:**

**Voter Behavior:** Voters are typically rationally ignorant, meaning they don't always take the time or effort to understand the full implications of public policies. The cost of being fully informed is high, but the personal benefit to any single voter is low (since one vote rarely decides an election). This ignorance can lead to increased demand for government spending because voters are less likely to critically assess the costs or efficiency of the programs they support.

**Voter Demands:** Voters, unaware of the full costs or long-term consequences, may demand more government services, leading to a situation where politicians, eager to gain favor, agree to expand public expenditure. For example, subsidies for certain industries or social programs can become entrenched, even if they are inefficient or unsustainable.

### **Bureaucratic Behavior:**

**Bureaucrats and Budget Maximization:** Bureaucrats are individuals working within government agencies. According to Public Choice Theory, bureaucrats are also driven by self-interest, specifically the desire to maximize their budgets and influence.

Bureaucrats may advocate for increasing their agency's budget and staff because a larger budget means more power and job security for them. They have little incentive to minimize government spending or reduce inefficiencies because these actions could reduce their power or job security.

**Empire Building:** Bureaucrats may push for the expansion of their agencies or the creation of new programs, even if they are not essential or beneficial to society. This empire-building behavior contributes to the overall increase in public expenditure over time.

### **Government Failure and Over-Expenditure:**

**Government Failure:** Public Choice Theory also suggests that government failure, rather than market failure, is often the cause of inefficient public expenditure. Political decision-makers do not necessarily act in the best interest of society as a whole. Instead, they respond to the incentives created by their own self-interests and the pressures from special interest groups, leading to inefficient allocation of resources.

**Budget Deficits and Debt:** Politicians may increase spending without regard for long-term fiscal sustainability, resulting in budget deficits and rising public debt. The cost of this increased debt is often postponed until after the politicians have left office, leading to a situation where public expenditure continues to rise without sufficient accountability.

### **Implications for Public Expenditure:**

#### **Over-Expansion of Government Spending:**

Public Choice Theory suggests that government spending tends to expand due to the interaction of self-interested politicians, bureaucrats, and voters. While the initial demand for government services may be driven by societal needs, it is often exacerbated by self-interested behavior. The political process encourages expansionary fiscal policies because of the incentives for politicians to cater to interest groups and deliver immediate benefits to voters, even if these policies lead to inefficiency or long-term budgetary problems.

#### **Inefficiency and Wasteful Spending:**

A key insight from Public Choice Theory is that government expenditure is not always directed toward its most efficient use. Due to rent-seeking, bureaucratic empire-building, and political favoritism, public resources are often directed toward projects or programs that have little overall societal benefit but provide concentrated benefits to certain groups. For example,



government subsidies for certain industries, or pork-barrel projects (e.g., building infrastructure that benefits a small political constituency), may lead to inefficient allocation of public funds.

#### **Difficulty in Curtailing Public Expenditure:**

Public Choice Theory also explains why it is difficult to reduce public expenditure, even in times of fiscal crisis. Once programs are established, they become politically entrenched, and politicians who seek re-election are reluctant to cut popular spending programs, even if they are inefficient or unsustainable. The status quo bias within political systems makes it difficult for governments to implement spending cuts, leading to an ongoing expansion of public expenditure over time.

**Demand Perspective:** Voters demand more public services (e.g., social security, healthcare, education) without a corresponding willingness to accept higher taxes, leading to pressure on governments to expand spending.

Politicians, in response to voter preferences and interest groups, often promise more spending to win elections, contributing to the growth of public expenditure.

**Supply Perspective:** Bureaucrats, according to this theory, may push for higher budgets to increase the scope and power of their departments, regardless of the actual need for those services.

Politicians may be incentivized to increase public expenditure to provide benefits to their constituents, even if it results in longterm fiscal imbalances.

**Explanation of Trends:** Public choice theory explains the persistent increase in government expenditure as a result of political incentives. Politicians are often reluctant to cut spending, fearing electoral backlash, leading to incremental growth in public expenditure over time.

#### **Keynesian Theory of Government Spending**

**Overview:** John Maynard Keynes argued that public expenditure could be used as a tool to manage aggregate demand and stabilize the economy. In Keynesian economics, government spending plays a countercyclical role, increasing during economic downturns and decreasing during periods of boom.

##### **Key Aspects:**

**Demand Perspective:** In times of economic recession, there is a fall in private sector demand. To offset this, governments increase public expenditure to stimulate demand and avoid prolonged economic downturns (e.g., infrastructure spending, unemployment benefits, welfare programs).

During economic booms, public demand for services may fall, allowing governments to scale back spending.

**Supply Perspective:** The government steps in to "supply" economic stimulus through increased spending in times of recession when private sector spending declines. It may borrow to finance this spending, with the aim of reducing the deficit during periods of economic growth.

**Explanation of Trends:** Over time, many governments have adopted Keynesian inspired policies, leading to increased public expenditure, especially during economic crises. This explains trends in rising public spending during recessions and crises, such as the global financial crisis of 2008 and the COVID19 pandemic.

## **Demographic Transition Theory**

**Overview:** This theory suggests that demographic changes, particularly aging populations, influence the demand for public services and the structure of government spending.

### **Key Aspects**

**Demand Perspective:** As populations age, there is an increasing demand for pensions, healthcare, and elderly care services. This demographic shift leads to greater pressure on public finances.

Younger populations may demand more spending on education, housing, and employment support.

**Supply Perspective:** The working population, which typically generates tax revenue, may shrink relative to the growing elderly population, limiting the government's ability to meet the rising demand for services.

### **Explanation of Trends:**

Many advanced economies are experiencing rising public expenditure on pensions, healthcare, and social security due to aging populations. This demographic trend explains the long term growth in public spending in areas like healthcare and retirement benefits.

Theories of demand and supply help explain the persistent and often accelerating growth of public expenditure over time. Economic development, political dynamics, technological changes, demographic transitions, and crises all interact to create rising demand for government services. Simultaneously, governments' ability to supply these services depends on fiscal policies, economic growth, and revenue generation. Overall, these theories provide a robust framework for understanding why public expenditure tends to increase as economies and societies evolve.

## **Public Services and the prevailing Economic Climate**

Public services, which encompass a wide range of government provided functions like healthcare, education, infrastructure, social security, and public safety, are significantly influenced by the prevailing economic climate. The relationship between public services and the economy is complex, with the economic environment affecting both the demand for and the government's ability to provide these services. Here's a detailed analysis of how the economic climate impacts public services:

### **Economic Growth and Public Services**

#### **Higher Growth, Increased Resources:**

In periods of economic growth, the government typically collects more revenue from taxes (income tax, corporate tax, VAT), allowing it to spend more on public services like education, healthcare, and infrastructure.

Economic prosperity often leads to expansion in public services, as citizens demand better infrastructure, higher quality education, and improved healthcare systems.

Growing economies also enable governments to invest in longterm infrastructure projects, boosting public services through better roads, public transport, energy supply, and digital infrastructure.

#### **Demand Dynamics:**

With growth, there's often increased demand for public services as people's incomes rise, expectations for quality public education, healthcare, and security increase.

Higher urbanization and industrialization driven by growth require more spending on urban infrastructure, public transportation, and utilities to sustain a rising standard of living.

**Examples:** In fast growing economies like China and India, public services such as transportation, education, and healthcare have expanded dramatically in recent decades to support rapid economic development.

## **Economic Recession and Austerity**

### **Reduced Fiscal Space:**

During economic downturns or recessions, tax revenues tend to decline as incomes fall and businesses struggle, reducing the government's capacity to fund public services.

Governments often face budgetary pressures during recessions, leading to cuts in spending on nonessential public services or the implementation of austerity measures. Areas like infrastructure investment, public employee salaries, and discretionary social programs may see reductions.

This period can also lead to deferred maintenance and underfunding of key services, leading to a decline in service quality over time.

### **Increased Demand for Public Services:**

Despite the fiscal pressures, recessions tend to increase the demand for public services, especially unemployment benefits, social welfare programs, and healthcare, as more people lose jobs and require state assistance.

This creates a paradox where the government must provide more services despite having fewer resources, often leading to deficit spending or increased borrowing to maintain essential services.

**Examples:** The 2008 global financial crisis saw many countries, particularly in Europe, implement severe austerity measures, cutting public services, reducing social welfare benefits, and freezing public sector wages, particularly in countries like Greece, Spain, and the UK.

In contrast, some countries, like the U.S., pursued expansionary fiscal policies to stimulate the economy, temporarily increasing public expenditure on unemployment benefits, infrastructure, and healthcare.

## **Inflationary Pressures and Public Services**

### **Cost Escalation:**

In a high inflation environment, the cost of providing public services increases as governments have to pay more for goods, services, and wages. For example, higher prices for construction materials can delay or inflate the costs of infrastructure projects.

Inflation erodes the purchasing power of public sector wages, leading to demands for wage increases from public sector employees (teachers, healthcare workers, police), further straining government budgets.

### **Impact on Public Spending:**

If governments do not adjust public sector wages or spending to match inflation, the quality of public services may deteriorate. However, adjusting for inflation may lead to an unsustainable rise in public expenditure.

Inflation can also lead to reduced investment in capital intensive public services like infrastructure, as borrowing costs rise due to higher interest rates.

**Examples:** In countries experiencing hyperinflation, like Zimbabwe in the 2000s or Venezuela in recent years, public services collapse as governments cannot afford the skyrocketing costs, leading to deteriorating healthcare, education, and basic infrastructure.

## **Unemployment and Public Services**

### **Increased Demand for Welfare Services:**

High unemployment rates, typically associated with recessions or structural economic changes, lead to increased demand for unemployment benefits, job training programs, and welfare services.

The economic climate of high unemployment places additional burdens on social safety nets, which may include food assistance, housing subsidies, and healthcare for unemployed individuals.

### **Challenges in Funding:**

High unemployment often coincides with reduced tax revenues, further straining the government's ability to fund these services.

Governments may have to borrow more to sustain public services or cut other areas of spending, leading to a reallocation of resources toward unemployment related services.

**Examples:** In the wake of the COVID19 pandemic, unemployment soared in many countries, and governments had to significantly expand public services related to unemployment insurance, job retention schemes, and social welfare. The U.S. CARES Act and similar initiatives in Europe increased public spending on unemployment benefits.

## **Government Debt and Fiscal Constraints**

### **Debt Servicing vs. Public Services:**

When a government accumulates high levels of public debt, a larger portion of its budget goes toward debt servicing (interest payments), which can crowd out spending on public services like healthcare, education, and infrastructure.

Fiscal constraints in heavily indebted economies often lead to cuts in public services or reduced quality, especially if governments are forced to implement austerity measures.

### **Balancing Debt with Service Provision:**

High debt levels can lead governments to seek external funding from institutions like the IMF or World Bank, which may impose conditions such as cuts to public expenditure in exchange for financial assistance. These conditions often target public sector wages, subsidies, and social welfare programs.

**Examples:** Countries like Greece during the European debt crisis had to severely cut back public services, including healthcare and education, as part of the austerity measures tied to bailout packages from the European Union and the IMF.

## **Technological Change and Public Services**

### **Improved Service Delivery:**

In times of economic prosperity, governments may invest in technology to improve the efficiency and effectiveness of public services. For example, e-governance can streamline service delivery, reduce corruption, and lower administrative costs.

Technological advancements in healthcare, education, and public infrastructure can increase the quality of public services, improving access and reducing costs in the long term.

### **Challenges of Technological Integration:**

During economic downturns, however, governments may not have the resources to invest in technological upgrades. This can result in outdated public services that are less efficient and more costly to maintain.

#### **Examples:**

Many advanced economies have invested in digital public services, such as online tax filing systems or telemedicine platforms, which have improved efficiency. In contrast, developing countries with weaker economic conditions may struggle to afford these technological upgrades.

### **Global Economic Integration and Public Services**

#### **Impact of Globalization:**

The global economic environment influences national public services. For instance, in a globally integrated economy, governments may need to invest more in areas like infrastructure and education to remain competitive.

Economic integration can also lead to outsourcing or privatization of certain public services to cut costs and improve efficiency, especially in economies facing fiscal constraints.

#### **Examples:**

Many countries have privatized services such as electricity, water, and telecommunications in response to economic pressures and global competition. The economic environment also shapes labor markets, affecting how public services like healthcare and education adapt to global standards.

### **Natural Disasters and Health Crises**

#### **Emergency Public Spending:**

Natural disasters or health crises (e.g., pandemics) often lead to sudden spikes in public expenditure, as governments need to allocate resources toward disaster relief, healthcare services, and infrastructure repair.

Such crises tend to lead to short term expansions in public services, though the capacity to sustain these services depends on the broader economic climate.

#### **Economic Recovery and Public Services:**

The economic aftermath of such events can either limit or expand public service provision. Governments may need to increase borrowing or cut other services to maintain essential services like healthcare during crises.

#### **Examples:**

During the COVID19 pandemic, governments across the world increased healthcare spending, launched public vaccination programs, and provided economic relief packages. The economic downturn following the pandemic forced many countries to reconsider long term public expenditure strategies to balance the need for continued service provision and economic recovery.

The prevailing economic climate—whether marked by growth, recession, inflation, or crises—profoundly affects both the supply and demand for public services. Economic growth allows governments to expand and improve public services, while recessions and fiscal constraints force difficult trade offs and may lead to service cuts or reduced quality. Understanding the relationship between economic conditions and public service provision helps policymakers navigate the complexities of managing public expenditure, ensuring that critical services are maintained even in challenging economic times.

## Lesson- 3: Public Revenue

### Lesson Objectives

After completing the lesson, you will be able to:

- Identify and classify public revenue sources, including taxes, fees, and international grants, and their impact on fiscal sustainability.
- Understand how direct and indirect taxes affect income distribution, economic efficiency, and public revenue.

Public revenue refers to the funds that the government collects to finance its activities, provide public services, and meet the needs of the economy. It plays a crucial role in maintaining government operations, driving development, and ensuring stability. The sources of public revenue can be broadly classified into tax revenue and nontax revenue, each with distinct characteristics.

### Classification of Public Revenue

#### Tax Revenue

**Direct Taxes:** Taxes levied directly on individuals or organizations, where the burden cannot be shifted to others.

**Income Tax:** Charged on personal or corporate income.

**Wealth Tax:** Levied on an individual's wealth or assets.

**Property Tax:** Paid on real estate properties, such as land or buildings.

**Capital Gains Tax:** Tax on the profit realized from the sale of assets like stocks or property.

**Indirect Taxes:** Taxes imposed on goods and services, where the tax burden can be passed on to consumers.

**Value Added Tax (VAT)/Goods and Services Tax (GST):** Tax levied on the consumption of goods and services.

**Excise Duty:** Charged on specific goods like alcohol, tobacco, or fuel.

**Customs Duty:** Levied on goods imported into a country.

**Sales Tax:** Imposed at the point of sale on retail goods.

#### Non-Tax Revenue

**Fees and Charges:** Payments for specific government services provided to the public.

**License Fees:** Fees paid for permits, such as driving licenses, or business operation permits.

**Registration Fees:** Charged for services like registering property or vehicles.

**Fines and Penalties:** Collected from individuals or businesses that violate laws or regulations (e.g., traffic fines, environmental violations).

**Dividends and Profits from State Owned Enterprises (SOEs):** Government earnings from investments in public sector companies.

**Rents from Government Properties:** Revenue from renting out government owned lands, buildings, or assets.

**Interest on Loans Given by Government:** Earnings from loans provided by the government to domestic or foreign entities.

**Grants and Aid:** Financial assistance received from foreign governments or international institutions (e.g., World Bank or IMF).

### **Capital Receipts**

These are nonrecurring sources of public revenue, often generated through borrowing or selling government assets. They do not directly increase the wealth of the state but provide temporary funding.

**Public Borrowing:** Money raised by the government through issuing bonds or taking loans from domestic or international markets.

**Sale of Public Assets:** Revenue generated from privatization or sale of government owned enterprises, properties, or resources.

**Recovery of Loans:** The return of principal amounts from loans that the government had earlier disbursed.

## **Characteristics of Public Revenue**

### **Tax Revenue Characteristics**

**Compulsory Nature:** Taxation is mandatory, meaning individuals and businesses are required by law to pay taxes. Noncompliance results in penalties.

**Non-Quid Pro Quo:** In contrast to fees and charges, taxes do not result in a specific service or benefit for the taxpayer. Instead, taxes fund general public services.

**Redistributive Function:** Progressive taxes like income tax are used to reduce income inequality by taxing wealthier individuals at higher rates and providing welfare programs to the disadvantaged.

**Elasticity:** Tax revenue tends to fluctuate based on economic activity. During periods of economic growth, income and corporate taxes increase. Conversely, in recessions, tax collections may decline.

**Diversity:** The tax system includes a wide range of direct and indirect taxes to ensure stability and avoid overreliance on a single source of revenue.

**Legal Obligation:** The collection of taxes is governed by national laws, and changes to tax rates or structures require legislative approval.

### **Non-Tax Revenue Characteristics**

**Voluntary Nature (in many cases):** Unlike taxes, non-tax revenue is often based on voluntary payments (e.g., when a person registers a vehicle or applies for a license).

**Specificity:** Nontax revenue is often tied to specific services or penalties. For example, license fees are collected for issuing driving licenses, and fines are levied for law violations.

**Dependence on Government Activities:** The amount of nontax revenue depends heavily on the level of government involvement in commercial activities, regulation, and ownership of enterprises.

**Less Redistributive:** Nontax revenue does not usually aim to redistribute income or wealth, unlike progressive taxation.

**Non-Economic Sources:** Some nontax revenue comes from noneconomic sources like grants, foreign aid, and fines, which are not tied directly to economic production or transactions.

**Less Volatile:** Compared to tax revenue, nontax revenue (especially from fees or dividends from state-owned enterprises) tends to be more stable over time.

## Capital Receipts Characteristics

**Non-Recurring:** Capital receipts are usually onetime or occasional sources of public revenue, such as proceeds from borrowing or asset sales.

**Liability Creation:** Borrowing increases government liabilities, as loans must be repaid with interest, unlike tax revenue.

**No Direct Economic Benefit:** Revenue from capital receipts does not directly reflect an increase in the government's wealth; it often represents borrowing or the conversion of assets into cash.

**Temporary Solution:** Capital receipts can provide temporary funding for public expenditure but are not a sustainable source of revenue for ongoing expenses.

**Privatization Proceeds:** Sale of government assets (e.g., privatization) can generate revenue but may also reduce future earnings from those assets.

## Importance and Role of Public Revenue

Public revenue is vital for financing public goods and services, ensuring economic stability, and promoting social welfare. The characteristics and classes of public revenue reflect a balance between compulsory taxation, voluntary payments for services, and temporary borrowing. The government relies on these revenues to manage:

**Public Infrastructure:** Roads, railways, airports, and digital infrastructure.

**Social Services:** Education, healthcare, social security, pensions, and unemployment benefits.

**Defense and Security:** National defense, law enforcement, and emergency services.

**Economic Development:** Funding for research and development, agriculture, and industry incentives.

## Challenges in Public Revenue Collection

**Evasion and Avoidance:** Tax evasion and avoidance reduce the effectiveness of tax systems and can lead to significant revenue losses.

**Economic Volatility:** Recessions, inflation, or unemployment can reduce tax revenues, leading to budget deficits.

**Inefficient Tax Systems:** Poorly structured tax systems may create distortions in economic activity, discourage investment, or unfairly burden certain groups.

**Dependence on External Grants:** Developing countries may be highly dependent on foreign grants or aid, which can make revenue streams unstable and reduce fiscal autonomy.

**Globalization:** International trade and finance complicate tax collection, particularly with multinational corporations and tax havens.

Public revenue is crucial for financing government activities, maintaining social welfare, and supporting economic development. The broad classification into tax and nontax revenue, each with its distinct characteristics, enables governments to diversify their revenue streams and ensure stable funding. Governments must carefully balance revenue collection to avoid overburdening taxpayers while ensuring sufficient funds to meet public needs.



**Relevant Questions:**

1. What are the key categories of public expenditure, and how do they impact economic growth?
2. How does the allocation of public expenditure differ between capital and recurrent expenses?
3. Why is public expenditure critical for achieving social welfare goals?
4. What are the economic and political factors that determine the distribution of public spending?
5. What are the primary economic, political, and social factors that influence public expenditure patterns?
6. How do demographic changes (e.g., aging populations) affect government spending?
7. In what ways do economic crises (like recessions or pandemics) alter public expenditure priorities?
8. How do demand side theories explain trends in increasing public expenditure over time?
9. What role do supply side factors, such as technological advancements, play in shaping public sector expenditure?
10. How do public expectations for services contribute to the growth in public expenditure?
11. How does the prevailing economic climate (inflation, growth rates, unemployment) influence the provision and quality of public services?
12. What adjustments do governments make to public service provision during economic downturns?
13. How does government spending on public services differ between periods of economic expansion and contraction?
14. What are the main sources of public revenue, and how do they differ in terms of reliability and sustainability?
15. How do direct and indirect taxes differ in their impact on income distribution and economic growth?

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## **Internal and External Revenue and Capital Financing**

**7**

### **Unit Highlights**

- Taxation; Borrowing and leasing; Fees and charges;
- Grants and subsidies, including international sources;
- Private sector sources of finance; Asset finance – securitization and leasing.

### **Technologies Used for Content Delivery**

- ❖ BOUTUBE
- ❖ BOU LMS
- ❖ WebTV
- ❖ Web Radio
- ❖ Mobile Technology with MicroSD Card
- ❖ BTV Program
- ❖ Bangladesh Betar Program



## **Lesson- 1: Sources of Internal and External Revenue**

### **Lesson Objectives**

After completing the lesson, you will be able to:

- Grasp the balance between taxation, borrowing, and other revenue sources, such as fees, charges, and international funding.
- Evaluate the advantages and limitations of different financing mechanisms (borrowing, grants, leasing) in public finance.

The sources of public revenue can be categorized into taxation, borrowing and leasing, fees and charges, grants and subsidies, and international sources. Each has unique characteristics and plays a different role in financing government activities. Let's delve into each of these in detail.

### **Taxation**

#### **Definition:**

Taxation is the most important and compulsory source of public revenue. It refers to the government's collection of money from individuals, businesses, and corporations to fund public goods and services, like infrastructure, education, and healthcare.

#### **Types:**

**Direct Taxes:** Imposed directly on individuals and businesses, based on income, wealth, or property.

**Income Tax:** Levied on personal and corporate income.

**Wealth Tax:** Charged on the total value of personal wealth, though less common now.

**Property Tax:** Based on the ownership of real estate or land.

**Indirect Taxes:** Taxes on goods and services where the payer can shift the burden to others (consumers).

**Sales Tax/VAT/GST:** Applied at the point of sale on goods and services.

**Excise Duties:** Imposed on specific goods like alcohol, tobacco, and fuel.

**Customs Duties:** Levied on imported goods.

#### **Characteristics:**

**Compulsory:** Payment of taxes is mandatory for citizens and businesses.

**Non-Quid Pro Quo:** No direct return of benefits to the payer. Taxes are pooled to fund public services.

**Revenue Generation:** Taxes provide a significant and recurring source of government revenue.

**Redistributive:** Taxation, especially progressive tax systems, can reduce income inequality by taxing higher earners at higher rates.

#### **Examples:**

In the U.S., federal income tax and state sales taxes provide essential revenue streams for government operations.

In Europe, value-added tax (VAT) is a major source of indirect taxation.

## **Borrowing and Leasing**

### **Definition:**

Borrowing refers to the funds a government raises by taking loans from domestic or international lenders. Leasing refers to revenue generated by leasing out government owned assets or properties.

### **Types of Borrowing:**

**Domestic Borrowing:** The government borrows from its citizens or domestic financial institutions by issuing bonds or treasury bills.

**External Borrowing:** Loans from foreign governments, international financial institutions (such as the IMF or World Bank), or foreign markets.

### **Types of Leasing:**

**Leasing Public Assets:** Governments lease public lands, buildings, or equipment to private companies or individuals.

**Resource Leasing:** Leasing rights to extract natural resources like oil, gas, or minerals from government owned land.

### **Characteristics:**

**Creates Liability:** Borrowing involves repayment with interest, creating future fiscal obligations.

**Non-recurring:** Borrowing is typically a onetime or infrequent source of revenue, used to cover deficits or fund large infrastructure projects.

**Debt Management:** Excessive borrowing can lead to debt crises, requiring careful fiscal management.

**Revenue from Leasing:** Leasing public assets can generate a continuous flow of revenue without permanently losing ownership.

### **Examples:**

**Government Bonds:** Many governments, such as the U.S. and Japan, issue bonds to finance deficit spending or large scale infrastructure projects.

**Leasing Ports or Airports:** Countries may lease national ports or airports to private operators to generate revenue while retaining ownership.

## **Fees and Charges**

### **Definition:**

Fees and charges are payments made by individuals and organizations to the government in exchange for specific services provided. Unlike taxes, fees are paid for direct benefits received from government services.

### **Types:**

**License Fees:** Charges for licenses (e.g., driving, business, fishing, or hunting licenses).

**Registration Fees:** Paid for registering property, vehicles, or births and deaths.

**User Charges:** Fees for using public utilities or infrastructure, such as toll roads, public transport, water, or electricity services.

**Court Fees:** Charges for filing lawsuits or using judicial services.

**Permit Fees:** Fees for permits like building permits or environmental permits for businesses.

**Characteristics:**

**Quid Pro Quo:** Fees and charges involve a direct exchange for a service or benefit from the government.

**Non-Compulsory:** Unlike taxes, fees are paid voluntarily when a service is requested.

**Revenue from Public Services:** Fees can provide consistent revenue for specific public services.

**Price Sensitivity:** Governments must balance setting appropriate fees that generate revenue without discouraging use of the services.

**Examples:**

In many countries, fees for driver's licenses, passports, or toll roads provide significant nontax revenue.

Public universities collect tuition fees from students to supplement government funding.

**Grants and Subsidies****Definition:**

Grants are non-repayable funds received by a government from domestic or international entities, while subsidies are financial aids provided by the government to support specific sectors, individuals, or businesses.

**Types of Grants:**

**Domestic Grants:** Transfers from one level of government to another (e.g., federal to state governments).

**International Grants:** Aid provided by foreign governments or international organizations, often for developmental projects, humanitarian aid, or environmental conservation.

**Types of Subsidies:**

**Agricultural Subsidies:** Financial support to farmers to stabilize food prices and encourage agricultural production.

**Energy Subsidies:** Support for renewable energy projects or lower fuel prices for consumers.

**Healthcare or Education Subsidies:** Financial assistance to lower the cost of healthcare or education for the public.

**Characteristics:**

**Non-Repayable:** Grants do not need to be repaid, unlike loans, making them attractive sources of funding.

**Conditional:** Many grants, especially international ones, come with conditions regarding how they are to be used.

**Income Support:** Subsidies often aim to support vulnerable industries or groups, promoting economic stability and social welfare.

**Examples:**

**Foreign Aid:** Countries like the U.S. or European nations often provide grants to developing countries for infrastructure, healthcare, or disaster relief.

**Agricultural Subsidies in the EU:** The European Union's Common Agricultural Policy (CAP) provides significant subsidies to farmers across member states.

## International Sources

### Definition:

International sources refer to financial assistance, loans, or grants that a government receives from foreign countries, international organizations, or global financial institutions.

### Types:

**Multilateral Aid:** Funding from international organizations like the World Bank, International Monetary Fund (IMF), or the United Nations (UN).

**Bilateral Aid:** Aid given directly from one country to another, often in the form of grants or concessional loans.

**Foreign Direct Investment (FDI):** Investment from foreign companies or individuals in domestic industries, often encouraged by government policies.

**Remittances:** Money sent home by citizens working abroad, although technically private income, it contributes to national income and can be taxed or used for public purposes.

### Characteristics:

**Developmental Focus:** International aid and grants are often directed toward developing countries for infrastructure, health, education, and governance projects.

**Tied Aid:** Some international funding comes with conditions, such as purchasing goods from the donor country or adhering to certain economic reforms (common with IMF loans).

**Foreign Exchange Impact:** International sources affect a country's foreign exchange reserves and can stabilize currencies or fund import heavy projects.

### Examples:

**IMF Loans:** Countries like Argentina or Greece have borrowed from the IMF to stabilize their economies during financial crises.

**World Bank Funding:** Projects like the construction of dams, roads, and schools in developing countries are often funded by World Bank loans.

These various sources of public revenue—taxation, borrowing and leasing, fees and charges, grants and subsidies, and international sources—each play distinct roles in financing government operations. Taxation is the primary and sustainable source of revenue, while borrowing and leasing provide temporary funds. Fees and charges help fund specific services, grants and subsidies support targeted sectors, and international sources bring in much needed development aid or foreign investments. Governments typically use a combination of these sources to finance their activities and promote economic stability and growth.



## **Lesson- 2: Private Sector Sources of Finance and Asset backed Financing**

### **Lesson Objectives**

After completing the lesson, you will be able to:

- Understand the role of private sector financing in public projects through mechanisms like public-private partnerships (PPPs).
- Evaluate the benefits and risks of private sector involvement in public financing, including securitization and leasing.
- Explore how asset backed financing mechanisms like securitization and leasing help manage public assets and liabilities.
- Understand the financial benefits and risks of using asset finance in the public sector.

### **Private Sector Sources of Finance:**

Private sector sources of finance refer to the various ways businesses, corporations, and individuals can raise funds for their operations, expansion, and investments. These sources range from internal funds generated by the business itself to external funding obtained through loans, investments, or capital markets. Below is an in depth exploration of the major private sector finance sources.

### **Internal Sources of Finance**

#### **Retained Earnings**

**Definition:** Profits that a company has earned and reinvests back into the business instead of distributing as dividends to shareholders.

#### **Characteristics:**

**No Interest or Obligation:** Unlike external funding, retained earnings do not come with repayment or interest obligations.

**Control:** Using retained earnings avoids external influence or control, as the business does not rely on external financiers.

**Limited Availability:** The amount of finance available is restricted by the company's profitability.

Examples: Companies may use retained earnings to fund new projects, research and development (R&D), or purchase new equipment.

#### **Asset Sale (Liquidation of Assets)**

**Definition:** Selling off nonessential or underutilized assets (e.g., equipment, real estate, or investments) to raise funds.

#### **Characteristics:**

**No Debt Incurred:** Selling assets generates cash without creating any liability or debt.

**Short-Term Solution:** Once sold, the assets cannot be recovered, so this is often a temporary solution.

**Limited Scope:** A business can only sell assets up to a certain point before it starts affecting operations.

Examples: A company selling an unused building or old machinery to finance new ventures.

## **External Sources of Finance**

### **Equity Finance**

**Definition:** Raising funds by selling shares of ownership in a company to investors. This can be done privately (e.g., venture capital) or publicly (e.g., through a stock exchange).

#### **Private Equity**

**Definition:** Investment from private individuals, firms, or institutional investors who provide capital in exchange for equity stakes in the business. This often includes venture capital (VC) or angel investing.

#### **Characteristics:**

**Long-Term Funding:** Private equity often comes with longterm involvement, with investors aiming for a return when the business grows or is sold.

**High Risk/High Reward:** Private equity investors expect high returns, as they often invest in high growth or riskier companies.

**Active Involvement:** Investors may take an active role in the company's management, often providing mentorship, industry connections, and strategic input.

**Examples:** A start up receiving venture capital from a VC firm in exchange for an equity stake.

#### **Public Equity (Stock Market)**

**Definition:** Raising capital by issuing shares to the public through an Initial Public Offering (IPO) or through subsequent public offerings on stock exchanges.

#### **Characteristics:**

**Access to Large Capital:** Going public allows companies to raise significant amounts of capital by selling shares to a broad range of investors.

**Dilution of Ownership:** Selling shares dilutes existing ownership, and shareholders may have a say in the company's management.

**Ongoing Reporting Requirements:** Public companies must meet strict regulatory and reporting requirements, including financial disclosures.

**Examples:** Companies like Apple, Tesla, and Amazon have raised billions by issuing shares on the stock market.

### **Debt Finance**

**Definition:** Borrowing money that must be repaid with interest, usually over a fixed term.

#### **Bank Loans**

**Definition:** A traditional method of financing where businesses borrow money from banks or financial institutions with an agreed upon interest rate and repayment schedule.

#### **Characteristics:**

**Fixed Terms:** Loans typically have fixed repayment schedules, interest rates, and maturity dates.

**Collateral Requirements:** Many loans require collateral (e.g., property, equipment) to secure the loan.

**Interest Payments:** Borrowing through loans incurs interest, which represents a cost of finance.

Examples: A company taking out a bank loan to fund expansion or new product development.

### **Corporate Bonds**

**Definition:** Companies can issue corporate bonds, which are essentially debt securities that investors buy. The company promises to pay back the principal along with periodic interest payments (coupons).

#### **Characteristics:**

**Fixed Interest Payments:** Bonds pay periodic interest to bondholders, typically at a fixed rate.

**Longer Term Debt:** Corporate bonds often have longer repayment terms than bank loans, offering more flexibility.

**No Ownership Dilution:** Unlike equity financing, bonds do not dilute ownership, as bondholders are creditors, not owners.

Examples: Large corporations like Microsoft and Coca Cola issue bonds to raise capital for long term projects.

### **Leasing**

**Definition:** A business can lease assets (e.g., machinery, vehicles, equipment) instead of buying them outright, allowing access to the assets without the high upfront costs.

#### **Characteristics:**

**Lower Upfront Costs:** Leasing allows businesses to use assets without the large initial capital outlay of purchasing.

**No Ownership:** The business does not own the asset; it's essentially renting it for a specified period.

**Tax Advantages:** Lease payments may be tax deductible as operating expenses.

Examples: A company leasing delivery trucks or production machinery.

### **Trade Credit**

**Definition:** An agreement where a supplier allows the business to purchase goods or services on credit, paying for them at a later date (e.g., 30, 60, or 90 days).

#### **Characteristics:**

**Short Term Finance:** Trade credit is typically a short term financing option.

**No Immediate Payment:** Businesses can acquire goods and services without immediate payment, improving cash flow.

**Dependence on Supplier:** This method relies on the trust and creditworthiness established with suppliers.

Examples: A retailer receiving goods from a supplier and paying for them 60 days later.

### **Factoring**

**Definition:** A business sells its accounts receivable (unpaid invoices) to a factoring company at a discount, receiving immediate cash in return.

### **Characteristics:**

**Immediate Cash Flow:** Factoring provides immediate cash based on outstanding invoices, improving working capital.

**Fees and Discount:** Factoring companies charge a fee or purchase invoices at a discount, meaning the business receives less than the full invoice value.

**No Debt:** Factoring is not a loan, so no debt is added to the company's balance sheet.

Examples: A small business selling its outstanding invoices to a factoring company to improve liquidity.

### **Venture Capital and Angel Investors**

**Venture Capital:** Professional investors or venture capital firms that provide funding to startups and early stage companies with high growth potential. In exchange, they receive equity and often become actively involved in management decisions.

**Angel Investors:** Wealthy individuals who invest their own money in start ups, often at an earlier stage than venture capitalists, providing mentorship as well as capital.

Private sector finance can come from a variety of sources, both internal and external. Internal sources, such as retained earnings and asset sales, provide companies with control and flexibility but are often limited. External sources, like equity financing, debt financing allow companies to access much larger amounts of capital but often come with trade offs such as dilution of ownership or repayment obligations. The choice of financing depends on the company's stage of development, needs, and financial strategy. By leveraging a combination of these sources, businesses can ensure sustainable growth and operational efficiency.

### **Asset Finance:**

Asset finance refers to the practice of using a company's physical assets or receivables to raise capital or fund its operations. Two major forms of asset finance are securitization and leasing. Let's break these down in detail:

#### **Securitization**

##### **Definition:**

Securitization is the process by which a company pools various types of assets (typically financial assets like loans, receivables, or mortgages) and sells them to investors in the form of securities. These securities are backed by the future cash flows generated from those assets, which gives investors a relatively secure income stream.

##### **Process of Securitization:**

**Asset Pooling:** The business pools together similar types of receivables or financial assets (e.g., mortgages, credit card debt, auto loans).

**Special Purpose Vehicle (SPV):** The pooled assets are transferred to a separate entity known as a Special Purpose Vehicle (SPV), which is created to isolate the assets from the originating company's balance sheet.

**Issuance of Securities:** The SPV issues securities, which are sold to investors. These securities are backed by the pooled assets and their associated cash flows.

**Servicing the Assets:** The originating company or a third party servicer continues to collect payments on the pooled assets (e.g., mortgage payments or credit card receivables) and passes these payments to the SPV, which then pays the investors.

### **Types of Assets Typically Securitized:**

**Mortgages (Mortgage Backed Securities, MBS):** Residential and commercial mortgages.

**Credit Card Receivables:** Outstanding balances on consumer credit cards.

**Auto Loans:** Loans taken to purchase vehicles.

**Student Loans:** Loans for educational purposes.

**Commercial Loans:** Loans extended to businesses.

### **Characteristics of Securitization:**

**Liquidity:** Securitization allows businesses to turn illiquid assets (like loans) into liquid capital by selling future cash flows upfront.

**Risk Transfer:** The risk associated with the pooled assets is transferred to investors rather than staying with the originating company.

**Off-Balance Sheet Financing:** Securitization can remove assets and related liabilities from a company's balance sheet, improving its financial ratios.

**Tranches:** The issued securities are often divided into different tranches, each with varying levels of risk and return. Higher risk tranches offer higher returns, while lower risk tranches offer more security.

### **Advantages:**

**Capital Raising:** It allows businesses to raise capital without taking on new debt or diluting ownership.

**Improved Liquidity:** Companies can access funds tied up in future receivables or assets immediately.

**Diversified Funding:** Securitization provides access to a broader pool of investors, including institutional investors.

### **Disadvantages:**

**Complexity:** The process is legally and financially complex, involving many parties (originator, SPV, investors, servicers).

**Risk of Default:** Investors bear the risk of defaults in the underlying assets (e.g., loan defaults).

**Market Risk:** The market for certain securitized assets can dry up, as happened during the 2008 financial crisis with mortgage backed securities.

### **Example:**

**Mortgage Backed Securities (MBS):** A bank may pool together home loans (mortgages) it has made to homeowners. It sells these loans to a Special Purpose Vehicle (SPV), which issues MBS to investors. The investors receive payments as homeowners make their monthly mortgage payments.

## **Leasing**

### **Definition:**

Leasing is a method of financing that allows a business to use an asset without buying it outright. Instead, the business (the lessee) makes regular payments to the owner of the asset (the lessor) for the right to use the asset over a specified period. Leasing is especially useful for acquiring expensive assets like machinery, vehicles, or office equipment.

### **Types of Leasing:**

#### **Operating Lease**

**Definition:** A short term lease where the lessee uses the asset for a period shorter than its useful life. Ownership remains with the lessor, and the asset is returned at the end of the lease term.

#### **Characteristics:**

**No Ownership Transfer:** The asset is returned to the lessor after the lease period.

**Maintenance:** In many cases, the lessor is responsible for maintaining the asset.

**Short Term:** Operating leases typically cover a portion of the asset's life and are cancellable.

**Example:** Leasing office space, vehicles, or IT equipment for a few years.

#### **Finance Lease (Capital Lease)**

**Definition:** A long term lease where the lessee effectively takes on the risks and rewards of owning the asset, even though legal ownership remains with the lessor.

#### **Characteristics:**

**Ownership Transfer:** In many cases, the lessee has the option to purchase the asset at the end of the lease term for a nominal amount.

**Full Asset Usage:** The lessee typically uses the asset for most of its useful life.

**Responsibility:** The lessee is responsible for maintaining and insuring the asset during the lease period.

**Example:** A company leasing a fleet of trucks for most of their useful life with an option to buy them at the end of the lease.

#### **Sale and Leaseback**

**Definition:** A company sells an asset it owns (such as equipment or real estate) to a lessor and then leases it back. This allows the company to access capital while still using the asset.

#### **Characteristics:**

**Immediate Cash Flow:** The sale provides immediate capital for the business.

**Continued Asset Use:** The company can continue using the asset, despite having sold it.

**Ownership Transfer:** The asset is sold to the lessor, but the company leases it back and can use it as before.

**Example:** A manufacturing company sells its factory but continues operating in it by leasing the premises.

### **Characteristics of Leasing:**

**Lower Initial Costs:** Leasing allows businesses to avoid the large upfront cost of purchasing an asset outright.

**Predictable Payments:** Leasing typically involves fixed, predictable payments, making it easier to budget.

**No Ownership:** In an operating lease, ownership never transfers to the lessee, meaning they avoid risks associated with depreciation.

**Tax Benefits:** Lease payments are often deductible as operating expenses, providing tax benefits to businesses.

### **Advantages:**

**Cash Flow Benefits:** Leasing requires smaller, periodic payments compared to buying, which helps preserve working capital.

**Flexibility:** Leases, especially operating leases, allow companies to upgrade to newer equipment or technology without the need to sell or dispose of owned assets.

**No Depreciation Risk:** The lessor typically bears the risk of the asset losing value over time (for operating leases).

### **Disadvantages:**

**No Ownership:** Unless it's a finance lease or purchase option, the business does not own the asset at the end of the lease.

**Higher Long Term Cost:** Leasing can be more expensive over the long term compared to outright purchase.

**Restrictions:** Lease agreements may include usage limits, maintenance requirements, or restrictions on modification.

### **Example:**

**Vehicle Leasing:** A company leases a fleet of delivery vans for five years, with fixed monthly payments. At the end of the lease, the company can return the vans and lease new ones, maintaining an up to date fleet without large upfront costs.

Securitization and leasing are both powerful asset finance tools but serve different purposes. Securitization is primarily used to unlock liquidity from a company's receivables or other financial assets, offering a way to raise funds without incurring new debt. Leasing, on the other hand, provides a way for businesses to access essential assets while preserving capital and reducing upfront costs. Both methods help businesses manage cash flow, mitigate risk, and fund growth efficiently.

### **Relevant Questions:**

1. What is the balance between taxation and borrowing in funding public expenditure?
2. How do grants and subsidies from international organizations influence public budgets?
3. What are the advantages and disadvantages of using fees and charges for public services over taxation?
4. How do governments manage the complexities of borrowing from international sources, such as the IMF or World Bank?
5. What role does the private sector play in financing public sector projects, and how are risks shared?
6. How do public-private partnerships (PPPs) reduce the financial burden on governments?
7. What are the challenges and benefits of using securitization in public sector finance?
8. How does securitization help governments manage their financial assets and liabilities?
9. What are the advantages of leasing public assets instead of outright ownership or borrowing for asset creation?
10. How do governments balance the risks associated with asset backed financing techniques like securitization?

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## **Origins and Implication of Public Borrowing and Debt**

**8**

### **Unit Highlights**

- Origins, structure, benefits, consequences and burden of public borrowing and public debt;
- Alternative approaches to the management of public borrowing and public debt;
- Debt and borrowing arrangements in national and sub-national public sector organizations; and Role of the Finance Ministry/Treasury in the management and control of public sector borrowing and debt.

### **Technologies Used for Content Delivery**

- ❖ BOUTUBE
- ❖ BOU LMS
- ❖ WebTV
- ❖ Web Radio
- ❖ Mobile Technology with MicroSD Card
- ❖ BTV Program
- ❖ Bangladesh Betar Program



## **Lesson- 1: Public Borrowing**

### **Lesson Objectives**

After completing the lesson, you will be able to:

- Analyze the structure of public borrowing (internal and external) and its role in funding government activities.
- Assess the long-term benefits and consequences of public debt, including the burden on future generations.
- Understand strategies for managing public debt, including debt restructuring, fiscal consolidation, and alternative financing (e.g., PPPs, sovereign wealth funds).
- Explore debt relief programs and innovative methods like debt for nature swaps to manage debt sustainably.

### **Origin of Public Borrowing:**

Public borrowing arises when governments finance budget deficits or fund large scale public projects (e.g., infrastructure) by borrowing money instead of raising taxes. Borrowing may be from domestic or international sources, such as issuing bonds or loans from financial institutions or international organizations (IMF, World Bank).

### **Structure of Public Borrowing:**

Public debt is categorized into:

**Internal Debt:** Borrowing from domestic lenders (banks, individuals, pension funds).

**External Debt:** Borrowing from foreign creditors or international agencies.

**Short-Term vs. Long-Term:** Short-term debt is repayable within a year, while long-term debt has longer maturity periods.

**Direct vs. Indirect:** Direct debt is the government's obligation, while indirect debt involves guarantees for other entities (e.g., state-owned enterprises).

### **Benefits of Public Borrowing:**

**Economic Growth:** Funds large scale infrastructure projects, boosting employment and growth.

**Crisis Management:** Allows governments to respond to economic crises (recessions, pandemics) without raising taxes.

**Smoothens Fiscal Deficits:** Helps manage fluctuations in revenue and expenditure, preventing abrupt austerity measures.

**Capital Market Development:** Regular issuance of bonds can deepen domestic financial markets.

### **Consequences of Public Borrowing:**

**Crowding Out:** Excessive borrowing may raise interest rates, limiting private investment.

**Inflationary Pressure:** Printing money to finance debt can cause inflation.

**Debt Servicing:** High interest payments can consume budget resources, limiting funds for essential services like healthcare or education.

### **Burden of Public Debt:**

**Intergenerational Debt:** Future generations bear the cost of repaying debt accrued today, potentially through higher taxes or reduced government spending.

**Debt Overhang:** When debt becomes unsustainable, it stifles economic growth and discourages investment.

**Sovereign Debt Crises:** Excessive borrowing can lead to default, causing economic instability and loss of investor confidence.

Effective public borrowing should strike a balance between funding essential projects and maintaining debt sustainability to avoid long term economic distress.

### **Alternative Approaches to the Management of Public Borrowing and Public Debt**

Managing public borrowing and debt is essential to ensure fiscal sustainability, economic stability, and continued access to capital markets. Governments need to carefully consider their approach to avoid excessive borrowing that could lead to debt crises. Below are detailed alternative approaches to effectively managing public borrowing and public debt.

#### **Fiscal Consolidation**

Fiscal consolidation refers to policies aimed at reducing government deficits and debt accumulation by increasing revenue, reducing expenditures, or both.

#### **Strategies:**

**Expenditure Cuts:** Reducing government spending, especially in nonessential sectors, while protecting critical investments like healthcare, education, and infrastructure.

**Revenue Enhancement:** Increasing tax revenues through more efficient tax collection, reducing tax evasion, or introducing new taxes, such as value added taxes (VAT) or carbon taxes.

**Rationalization of Subsidies:** Phasing out inefficient subsidies that strain public finances without contributing to economic growth, such as fossil fuel or agricultural subsidies that disproportionately benefit wealthy sectors.

#### **Benefits:**

**Lower Deficits:** Reduces the need for borrowing by balancing the budget.

**Credibility:** Markets and investors often respond positively to governments that take decisive steps to stabilize their debt situation.

#### **Challenges:**

**Social and Political Resistance:** Expenditure cuts and tax increases are often politically unpopular, especially during periods of economic hardship or austerity.

#### **Debt Restructuring**

Debt restructuring involves negotiating new terms with creditors to make public debt more manageable without defaulting.

### **Strategies:**

**Re-profiling:** Extending the maturity of debt to spread out repayments over a longer period, reducing the immediate burden on public finances.

**Haircuts:** Creditors agree to reduce the principal or interest payments on debt, recognizing that they may not be fully repaid.

**Debt for Equity Swaps:** Debt can be converted into equity stakes in public assets, reducing the immediate need for repayment.

**Brady Bonds:** Developing countries can convert existing debt into long term, lower interest bonds with partial guarantees from institutions like the IMF.

### **Benefits:**

**Debt Sustainability:** Helps lower the immediate repayment burden and avoids defaults.

**Creditor Cooperation:** By negotiating, creditors avoid total losses from defaults while governments can better manage their debt obligations.

### **Challenges:**

**Reputation Risks:** Frequent restructuring or seeking debt relief can undermine investor confidence.

**Conditionality:** Debt restructuring often comes with conditions imposed by creditors (e.g., IMF austerity programs).

### **Diversifying Borrowing Sources**

Rather than relying heavily on a single source of borrowing, governments can diversify to manage risks better and reduce borrowing costs.

### **Strategies:**

**Domestic and External Borrowing Mix:** Balancing between borrowing from domestic markets (banks, pension funds) and international markets (foreign investors, multilateral institutions).

**Issuing LongerTerm Bonds:** Longterm bonds reduce the risk of frequent refinancing and improve debt maturity profiles.

**International Financial Institutions (IFIs):** Leveraging concessional loans from institutions like the World Bank and the International Monetary Fund (IMF) can provide lower interest rates and more flexible repayment terms compared to market borrowing.

### **Benefits:**

**Lower Borrowing Costs:** Access to multiple markets and sources can reduce the cost of borrowing by fostering competition among lenders.

**Reduced Currency Risk:** Borrowing domestically reduces exposure to exchange rate fluctuations that can raise the cost of servicing external debt.

### **Challenges:**

**(a) Debt Market Dependency:** Overreliance on foreign borrowing exposes countries to shifts in global financial conditions.

**Refinancing Risks:** Short term or float ingrate debt can lead to refinancing issues in times of financial distress.

### **Debt Transparency and Governance**

Improving the transparency and governance surrounding public borrowing ensures more responsible management of public debt.

#### **Strategies:**

**Debt Management Offices (DMOs):** Establishing independent debt management offices that focus on long term strategies for managing public debt and coordinating with fiscal policy.

**Debt Audits:** Conducting audits of public debt to ensure accountability and identify illegitimate or unsustainable borrowing practices.

**Public Debt Reporting:** Publishing clear, regular reports on debt levels, borrowing plans, and risks to increase transparency and build investor confidence.

#### **Benefits:**

**Increased Investor Confidence:** Transparent and well governed borrowing practices can attract more favorable lending terms.

**Better Risk Management:** Identifying potential fiscal risks early allows for better management of borrowing strategies.

#### **Challenges:**

**Implementation:** Developing countries may struggle to establish sophisticated debt management frameworks due to limited institutional capacity.

### **Use of Sovereign Wealth Funds (SWFs)**

Sovereign wealth funds can be used to stabilize budgets, reduce reliance on borrowing, or repay public debt.

#### **Strategies:**

**Revenue Stabilization Funds:** Countries with volatile revenues (e.g., oilexporting nations) can set up SWFs to save excess revenue during boom periods and draw on these funds during downturns, reducing the need for borrowing.

**Debt Repayment:** Governments can use surplus reserves in SWFs to pay down public debt, reducing future debt servicing costs.

**Strategic Investments:** Some SWFs focus on earning returns by investing in global markets, generating revenue streams that help offset the need for borrowing.

#### **Benefits:**

**Buffer Against Shocks:** SWFs provide financial stability in times of revenue downturns, reducing dependence on external borrowing.

**Lower Debt Levels:** Using SWF funds to pay down debt reduces the overall debt burden on future generations.

**Challenges:**

**Dependence on Commodities:** In resource rich countries, SWFs are often dependent on volatile commodity prices.

**Opportunity Costs:** Using SWF reserves for debt repayment may come at the cost of potential future investment returns.

**Monetary Financing (Quantitative Easing and Inflation Management)**

Governments, particularly those with control over their central banks, can use monetary policy tools to manage debt.

**Strategies:**

**Quantitative Easing (QE):** Central banks purchase government bonds to inject liquidity into the economy, reducing long term interest rates and lowering the cost of government borrowing.

**Inflation Management:** In a controlled manner, allowing moderate inflation can erode the real value of debt over time, making it easier to repay.

**Benefits:**

**Lower Interest Rates:** QE reduces interest rates, making debt servicing more affordable.

**Debt Erosion via Inflation:** Inflation reduces the real value of outstanding debt, benefiting governments with long term fixed rate obligations.

**Challenges:**

**Inflation Risks:** Excessive reliance on QE or inflationary policies can lead to hyperinflation, undermining economic stability.

**Market Distortion:** QE can distort bond markets, leading to asset bubbles and longterm imbalances in the financial system.

**Debt Swaps (e.g., Debt for Climate or Debt for Nature Swaps)**

Debt swaps allow countries to convert part of their debt into investments in specific social or environmental projects.

**Strategies:**

**Debt for Climate Swaps:** International creditors agree to reduce a country's debt in exchange for commitments to invest in climate related projects, such as renewable energy or conservation.

**Debt for Nature Swaps:** Debt is forgiven in exchange for investments in biodiversity conservation, reforestation, or other environmental initiatives.

**Benefits:**

**Debt Reduction:** These swaps reduce debt levels while allowing countries to focus on environmental or social goals.

**Positive Externalities:** Investments made under these swaps promote longterm environmental sustainability and may attract further international aid or investment.

**Challenges:**

**Limited Applicability:** These swaps are typically available to countries facing economic hardship, and the scope of debt relief may be limited.

**Complex Negotiations:** Debt swaps require lengthy negotiations with creditors and international organizations.

**Balanced Budget Rules and Fiscal Responsibility Laws**

Governments can implement fiscal rules to constrain public borrowing and ensure responsible fiscal management.

**Strategies:**

**Balanced Budget Amendments:** Legally binding rules that require governments to balance their budgets or maintain a sustainable fiscal deficit (e.g., less than 3% of GDP).

**Debt Ceilings:** Establishing a cap on the amount of debt the government can accumulate, limiting excessive borrowing.

**Fiscal Responsibility Laws:** Laws mandating fiscal discipline, transparency, and longterm sustainability in government budgeting and borrowing.

**Benefits:**

**Debt Sustainability:** Prevents runaway borrowing and fosters longterm fiscal responsibility.

**Investor Confidence:** Adhering to fiscal rules increases confidence in the government's ability to manage its debt, often leading to lower borrowing costs.

**Challenges:**

**Rigid Fiscal Space:** Strict fiscal rules may limit a government's ability to respond to economic downturns or emergencies.

**Political Resistance:** Implementing balanced budget laws can be politically contentious, especially during times of fiscal stress.

Managing public borrowing and debt requires a comprehensive, flexible approach tailored to the economic conditions and fiscal goals of a country. Effective management strategies combine fiscal discipline, debt diversification, transparent governance, and innovative approaches like debt restructuring or debt swaps. By balancing short term needs with long term sustainability, governments can reduce the risks associated with excessive public debt while promoting economic growth and financial stability.



## **Lesson- 2: National and Subnational borrowing and Role of Ministry of Finance**

### **Lesson Objectives**

After completing the lesson, you will be able to:

- Examine the differences between national and subnational borrowing in terms of regulatory oversight and credit access.
- Understand how finance ministries regulate subnational borrowing to prevent unsustainable debt levels.
- Understand the role of the Ministry of Finance in managing public debt, including debt issuance, risk management, and fiscal policy alignment.
- Explore the coordination between the Ministry of Finance, central banks, and international lenders to maintain debt sustainability and manage borrowing.

### **Debt and Borrowing Arrangements in National and Sub-National Public Sector Organizations**

#### **National Level Public Borrowing**

At the national level, public borrowing typically involves central government activities aimed at financing budget deficits, funding large scale infrastructure, or responding to economic crises. National borrowing can take various forms:

**Sovereign Bonds:** The central government issues bonds to domestic or international investors, which may include treasury bills (shortterm), notes (mediumterm), or bonds (longterm).

**Loans from International Institutions:** National governments often borrow from the International Monetary Fund (IMF), World Bank, or regional development banks. These loans are typically concessional, meaning they offer lower interest rates and longer repayment terms than market loans.

**Foreign Currency Debt:** Governments may issue debt denominated in foreign currencies (e.g., US dollars, euros) to attract international investors.

**Bilateral Loans:** Governments may engage in bilateral borrowing arrangements with other countries, often as part of trade or development agreements.

#### **Sub-National Borrowing (State/Regional/Local Governments)**

Subnational entities, such as state, regional, or local governments, also engage in borrowing to finance public services, infrastructure projects, and day to day operations.

**Municipal Bonds:** Cities, municipalities, or regional governments may issue bonds to finance large infrastructure projects, such as roads, schools, or utilities.

**State Loans:** Subnational entities may borrow from national governments through intergovernmental loans or grants.

**Bank Loans:** Subnational governments may secure loans from commercial or stateowned banks.

**Project Finance and Public-Private Partnerships (PPPs):** Subnational entities may enter into PPPs to finance infrastructure projects, where private sector involvement reduces direct borrowing needs.

## **Differences Between National and Sub-National Borrowing:**

**Credit Ratings:** Subnational entities may have different credit ratings from national governments, which can influence borrowing costs.

**Regulation and Oversight:** National governments often regulate or limit subnational borrowing to maintain fiscal discipline and prevent excessive debt accumulation at lower levels of government.

## **Role of the Ministry of Finance (or Treasury) in the Management and Control of Public Sector Borrowing and Debt**

The Ministry of Finance or Treasury plays a central role in managing and controlling public borrowing and debt to ensure fiscal sustainability and macroeconomic stability. Its functions include:

### **Debt Management**

The Ministry of Finance is responsible for overseeing public debt management. This involves creating strategies to minimize borrowing costs, managing repayment schedules, and ensuring that the debt portfolio remains sustainable. Key activities include:

**Issuing Debt:** The ministry organizes and executes the issuance of government bonds, treasury bills, and other debt instruments. It determines the appropriate maturity structure, interest rates, and timing for these issuances.

**Debt Sustainability Analysis:** The ministry conducts debt sustainability assessments to evaluate the country's ability to service its debt without undue economic strain.

**Debt Service Management:** It oversees the timely repayment of debt obligations (interest and principal), ensuring the government avoids defaults or refinancing issues.

**Monitoring External Debt:** The ministry tracks the country's exposure to external creditors, foreign currency fluctuations, and global interest rate trends.

### **Coordination between National and Sub National Borrowing**

To prevent unsustainable borrowing at the subnational level, the Ministry of Finance often regulates subnational borrowing through:

**Borrowing Limits:** Setting caps on how much subnational governments can borrow or imposing approval processes for large loans or bond issuances.

**Fiscal Rules:** Imposing fiscal responsibility rules, such as balanced budget requirements or debt limits for states and municipalities.

**Debt Reporting and Transparency:** Requiring subnational governments to report their debt levels, borrowing plans, and fiscal health to the national Ministry of Finance for monitoring.

### **Fiscal Policy and Budgeting**

The Ministry of Finance plays a crucial role in aligning public borrowing with broader fiscal policy objectives. Responsibilities include:

**Budget Deficit Management:** The ministry plans borrowing levels based on projected budget deficits. Borrowing is used to finance gaps between government revenue and expenditure.

**Coordination with Central Bank:** The ministry works closely with the central bank to manage borrowing without causing inflation or destabilizing the financial system. This includes setting appropriate borrowing limits and managing monetary financing risks (such as inflation caused by excessive money printing).

**Debt Targeting:** The ministry may set targets for debt to GDP ratios to maintain fiscal sustainability and ensure that borrowing remains within manageable levels.

### **Risk Management and Diversification**

The Ministry of Finance actively manages risks associated with public borrowing and debt by:

**Currency Risk Management:** Monitoring and mitigating the risk of currency fluctuations in external debt portfolios by balancing between domestic and foreign currency borrowing.

**Interest Rate Risk Management:** Issuing a mix of fixed rate and floating rate debt to manage the risk of rising interest rates that could increase debt servicing costs.

**Debt Portfolio Diversification:** Ensuring that public debt is diversified across various maturity periods and debt instruments to spread refinancing risk over time.

### **Public Debt Transparency and Accountability**

The Ministry of Finance is responsible for ensuring transparency in public debt management. This helps maintain market confidence and accountability, and it includes:

**Public Reporting:** Publishing regular reports on the stock of public debt, borrowing plans, and debt servicing obligations. These reports help investors, credit rating agencies, and the public assess the government's fiscal health.

**Debt Audits:** Conducting periodic audits of public debt to ensure transparency and prevent mismanagement or corruption in borrowing practices.

### **Negotiating International Debt Agreements**

In the case of external debt, the Ministry of Finance plays a central role in negotiating terms with international lenders, such as the World Bank, IMF, or other bilateral creditors. Key functions include:

**Loan Negotiations:** Securing concessional loans with favorable terms (low interest rates, longer maturities) to reduce the cost of external borrowing.

**Debt Restructuring:** When needed, the Ministry negotiates debt restructuring agreements with creditors, including extending maturities, reducing interest rates, or obtaining partial debt forgiveness.

**Debt Relief Programs:** For heavily indebted countries, the Ministry may engage in international debt relief programs (e.g., the Heavily Indebted Poor Countries initiative) to reduce the debt burden.

### **Public-Private Partnerships (PPP) and Alternative Financing**

The Ministry of Finance explores alternative financing mechanisms, such as public-private partnerships (PPPs), to reduce the need for direct public borrowing.

**PPP Framework:** Developing legal and regulatory frameworks that enable private sector participation in infrastructure projects, thus shifting some financing burdens away from the public sector.

**Risk Sharing:** Structuring PPPs so that the private sector assumes some risks, such as construction, operational, and financial risks, reducing the strain on public debt.

The management of public sector borrowing and debt is a complex task involving coordination between national and subnational governments. The Ministry of Finance or Treasury plays a central role in this process, ensuring that borrowing aligns with fiscal policy objectives, managing risks, and ensuring transparency and accountability. By establishing clear rules,

monitoring debt levels, and utilizing diversified borrowing strategies, the Ministry of Finance helps maintain public debt sustainability and contributes to long-term economic stability.

**Relevant Questions:**

1. How do national and subnational borrowing arrangements differ in terms of access to capital and regulatory oversight?
2. What mechanisms are in place to ensure that subnational governments do not accumulate unsustainable debt levels?
3. How do national finance ministries control and manage public borrowing at both national and subnational levels?
4. What is the role of the Ministry of Finance or Treasury in managing public debt and borrowing?
5. How does the finance ministry ensure debt sustainability while balancing short term fiscal needs?
6. What tools does the Ministry of Finance use to mitigate risks associated with currency and interest rate fluctuations in public debt?
7. How does the finance ministry coordinate with central banks and international lenders to manage external borrowing?

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