PUBLIC FINANCE AND FISCAL POLICY

Public finance is a section of microeconomics which is concerned with public revenue and public expenditure. It is therefore concerned with the various sources of public revenue and the different areas where the state spends money in order to achieve major objectives of national development.

BRANCHES OF PUBLIC FINANCE

Public finance consists of five (5) branches and these include;

1. Public revenue
2. Public debt/ borrowing
3. Public expenditure
4. Fiscal policy
5. Financial administration.

PUBLIC REVENUE

This is concerned with the methods of raising public revenue and the principles of taxation.

SOURCES OF PUBLIC REVENUE

1. **Taxes.** This is the main source of government revenue.
2. **Borrowing** both from internal and external source.
3. **Gifts and grants.** These are contributions made by individuals to the government to meet the costs of specific projects or skills to cater for public interest and they may be from within or outside the country.
4. **Surplus earnings from gambling** e.g. national lottery
5. **Disinvestment/ privatization.** This refers to the sale of government or state owned firms to private individuals.

6. **Profits earned from government productive activities** e.g. government owned industries, public corporations.

7. **Compulsory savings** e.g. insurance payments and social security funds (NSSF)

8. **Printing more money.**

FEES (NON-TAX SOURCES)

Fees are payments made by individuals or firms to public authorities for any service rendered to them by the state.

9. **Fines and penalties.** They are payments made by law breakers.

10. **Rates.** These are payments made for urban property.

11. **Market dues.** These are payments made to get a right to sell goods or commodities in a market.

12. **Licenses.** These are payments made to be allowed to operate or start a business.

13. **Road tolls/ bridge tolls.**

TAXATION

Taxation refers to the legal compulsory transfer of money from individuals and companies to the government as a source of revenue.

A tax is a compulsory payment or contribution made by an individual or firm to the public authorities regardless of the expected benefits.

A tax is a non-quid proquo payment in the sense that the benefits received by the tax payer from the government do not necessarily correspond with the amount of tax paid i.e. it can be greater or less.

CANONS/ PRINCIPLES OF TAXATION

These are guidelines, regulations or procedures followed during tax assessment and administration. Adam Smith was the first economist who laid down four (4) important canons of taxation which were later added on by other economists. They are explained below.

1. **Canon of equity/ fairness.** This principle is divided into two; i.e. horizontal and vertical equity. Horizontal equity requires that individuals who are the same in all relevant aspects be treated the same. The principle of vertical equity says that some individuals are in position to pay higher taxes than other and that these individuals should do so.

2. **Canon of certainty.** The nature of the tax, its base, the amount to be paid, when to pay and where to pay should be known clearly by both the tax payer and the tax collector.

3. **Canon of convenience.** Taxes should be collected at a time, season and availability of income. Therefore taxes should be collected at a time when the tax payer has had opportunity to sell.

4. **Canon of economy/ efficiency.** The cost of collecting taxes should be substantially lower than the actual tax realized. The cost of collecting taxes should not exceed 5% of its yield.

5. **Canon of comprehensiveness/ diversity.** There should be a variety of taxes so that all citizens contribute towards state's revenue according to their ability to pay. There should be a variety of direct and indirect taxes.

6. **Canon of consistency.** The tax system should be in line with national economic objectives especially in allocation of resources.

7. **Canon of elasticity/ flexibility.** There should be no rigidity in the tax system. It should change with change in the tax payer's income i.e. should increase when income increase and decrease when income falls.

8. **Canon of neutrality/ impartiality.** This requires the tax system not to discriminate the tax payers. All those with the same ability to pay should pay same amounts without any form of discrimination.

9. **Canon of optimality.** The tax payers should get maximum satisfaction through public/ government expenditures hence promoting increase in productive capacity of the country.

10. **Canon of productivity.** A good tax system should be able to generate enough tax revenue for the government but should not negatively affect production of goods and services in the economy therefore should not discourage investment.

11. **Canon of simplicity.** The tax system should be easy to understand hence should not be complicated i.e. the nature of the tax, amount to be paid and time of collection should easily be understood by both the tax payer and tax collector.

FEATURES/ CHARACTERISTICS OF A GOOD TAX SYSTEM

- It should be equitable/ fair
- It should be certain
- It should be convenient
- It should be economical/ efficient
- It should be comprehensive/ diverse
- It should be elastic/ flexible
- It should be neutral/ impartial
- It should be optimal.
- It should be productive
- It should be simple
- It avoids double taxation.
- It is based on the ability to pay principle.
- Has a built in stabilizer.

FACTORS THAT INFLUENCE THE LEVEL OF TAX REVENUE IN DEVELOPING COUNTRIES

1. **Level of income.** The higher the level of income of an individual, the higher the tax revenue because an individual has enough for paying the tax and saving while the lower the level of income, the lower the tax revenue because people are unable to earn what is enough for their consumption and paying tax.

2. **Degree of accountability by the tax officials.** A high level of corruption among government officials retards economic activities because they have swindled the money that was supposed to facilitate them hence low tax revenue while a low level of corruption among officials avails funds for different economic activities hence high level of tax revenue.

3. **Level of development of infrastructure.** A good infrastructural development leads to high levels of tax revenue because goods and raw materials are cheaply transported to market centres while poor infrastructural development increases costs of transportation of goods and services hence low tax revenue.

4. **The political climate.** A favourable political climate enables producers to concentrate on the production process which leads to high quality output hence high tax revenue while unfavourable political climate destroys existing infrastructure, puts producers on tension leading to low output hence low tax revenue.

5. **Stock of capital.** A high level of stock of capital avails funds for investments which enlarges the production scale leading to increased output and profits hence high tax revenue while low level of capital stock leads to low tax revenue because people do not have funds to buy the necessary equipments to enlarge their businesses.

6. **Level of income distribution.** A fair and equal income distribution enables both the poor and the rich to access several goods and services hence high tax revenue while unfair income distribution discourages consumers from accessing goods and services hence low tax revenue.

7. **Level of technology.** A high level of technology encourages utilization of the available resources which leads to increased output hence high tax revenue while poor technology leads to underutilization of resources and production of poor quality output hence low tax revenue.

8. **Rate of inflation.** The higher the rate of inflation, the lower the tax revenue because money continuously loses value and investments are discouraged because of the high costs of production while low inflation rates lead to high tax revenue since the value of money is high and investments are also promoted.

9. **Level of employment.** The higher the level of employment, the lower the level of tax revenue. This is because unemployment leads to a certain portion of the population having no incomes on which taxes can be levied while the lower the level of unemployment, the higher the tax revenue because majority of individuals earn incomes on which government can impose taxes.

10. **Level of tax evasion and avoidance.** High levels of tax evasion and avoidance by the tax payers due to lack of commitment by the tax officials or existence of loopholes in the tax law leads to low levels of tax revenue since many activities are carried out without being taxed while low levels of tax evasion and avoidance lead to high levels of tax revenue since most of the activities are taxed.

11. **Availability of data or information.** Availability of data in peoples' incomes and profits of companies leads to high levels of tax revenue because there is reduced evasion of tax payment while inadequate information concerning peoples' incomes and companies' profits leads to low level of tax revenue because many activities go without being taxed.

12. **Level of monetization of the economy.** A large subsistence sector is associated with low levels of tax revenue because production of goods is mainly for own consumption and thus there is no income earned on which government can impose taxes while existence of a highly industrialized monetary economy leads to high levels of tax revenue since many people earn incomes on which taxes can be imposed.

13. **The level of skills of tax administrators/ collectors.** Highly skilled tax administrators have the ability to carry out the tax assessment and administration process effectively so as to raise enough revenue for the government hence high levels of tax revenue while incompetent tax administrators end up harassing the tax payers and this increases the chances of tax evasion hence low tax revenue.

14. **The rates imposed on tax payers.** The higher the tax rates imposed on tax payers, the higher the revenue collected and the lower the tax rates, the lower the revenue collected. The government earns more revenue through the use of a progressive tax system rather than the regressive tax system.

15. **The level of incentives/ tax concessions/ tax exemptions given to the potential tax payers.** The high level of tax exemptions especially on foreign investors who would otherwise be potential tax payers narrows the tax base hence low tax revenue while low level of tax exemptions widens the tax base hence high tax revenue.

16. **The cost of tax collection.** The higher the cost of tax collection, the lower the level of tax revenue as a lot of money is used to reach out to the tax payers while the lower the cost of tax collection, the higher the level of tax revenue.

17. **The level of service delivery provided by the state from tax revenue.**

TAX BASE

Tax base is the income/ item/ wealth/ person/ economic activity on which a tax is levied to raise tax revenue.

REASONS FOR NARROW TAX BASE IN UGANDA/ CAUSES OF LOW TAX REVENUE IN LDCS

1. **Small industrial sector.** Uganda's industrial sector is small and weak yet it is the major source of tax revenue. This results into less output leading to low tax returns/ limited number of economic activities.

2. **Political instability in some parts of the country.** This leads to destruction of productive infrastructure that facilitate production of goods and services where taxes are easily imposed and this political state also scares tax officials from reaching all parts of the country where taxes can easily be obtained.

3. **High levels of unemployment.** Many people in Uganda have no stable jobs hence receive small or no incomes on which tax is easily levied leading to narrow tax base

4. **Existence of large subsistence sector.** Many people in Uganda produce for own consumption and not for the market and this results into low output and low incomes leading to a narrow tax base.

5. **Underdeveloped infrastructure for example inaccessible roads and poor telecommunication networks.** This makes it difficult to access all potential tax payers especially in rural areas and also the poor state of infrastructure limits productive activities where taxes can easily be imposed from taking place.

6. **Granting of excessive tax exemptions and tax holidays to potential tax payers.** This is mainly done to attract investors but as this is being done, government loses a lot of revenue since such people participate in production without paying taxes for a certain period of time granted them by the government.

7. **Limited data or information about peoples' earnings.** Many people in Uganda have different sources of income but they are not known by the tax officials hence unable to tax them resulting into low tax revenue.

8. **Low levels of incomes.** Many people in LDCs have extremely low incomes therefore they cannot easily be subjected to taxation as this would negatively affect their standard of living.

9. **High levels of corruption and embezzlement among tax officials.** The little tax revenue collected is also diverted by corrupt tax officials for personal use while some of them are bribed hence exempting some potential tax payers from making tax payments resulting into low tax revenue.

10. **Limited skills possessed by tax administrators.** Most of the tax administrators are not well trained to carry out tax assessment and administration. As a result, many services are not taxed while some officials use brutal methods during tax collection hence making people to hate tax payment.

11. **Low tax rates imposed on some of the high income earners for example judges, armed forces among others.** This also limits government from acquiring adequate revenue.

12. **High cost of tax collection and administration.** The process of collecting taxes in LDCs

involves many officials in charge of assessment, collection, monitoring and evaluation which makes it very expensive to sustain all of them leading to heavy expenditure using the tax revenue collected.

13. **High degree of tax evasion and avoidance by tax payers.** This is mainly due to lack of commitment by the tax officials and existence of loopholes in the tax law. As a result, many activities are carried out without being taxed hence low tax revenue.

14. **Etc.**

MEASURES TO INCREASE TAX BASES

- Develop infrastructure.
- Monetize the economy.
- Improve the skills of tax administrators.
- Develop the industrial sector.
- Avoid unnecessary/ reduce tax concessions.
- Liberalize trade.
- Diversify the economy.
- Privatize state enterprises/ public sector assets.
- Encourage investment
- Improve the political atmosphere.
- Fight corruption
- Sensitize the masses about the role of taxation.
- Etc.

TAXABLE CAPACITY

Taxable capacity refers to the extent to which a tax payer can pay the tax assessed on him and yet remain with enough disposable income to enable him and his family lead a standard of living they are accustomed to.

OR

Taxable capacity (of a nation) is the extent to which a nation can raise the expected revenue through paying taxes without producing socially, economically and politically harmful effects.

FACTORS THAT INFLUENCE TAXABLE CAPACITY IN LDCS

1. **The level of income of the tax payers.** The higher the level of income of the tax payers, the higher the taxable capacity since tax payers have sufficient income for tax payment without affecting their standard of living while low level of income of tax payers leads to low taxable capacity as tax payers have less income for tax payment.

2. **The level of infrastructural development.** Highly developed infrastructure promote economic activities where taxes are levied and enable tax officials to reach all tax payers leading to high taxable capacity since tax officials cannot easily reach all potential tax payers in the country.

3. **The number of tax bases.** The higher the number of tax bases, the higher the taxable capacity of the nation since all those tax bases are subjected to taxation while limited number of tax bases leads to low taxable capacity as there are few items that are subjected to taxation.

4. **Degree of monetization of the economy.** A large subsistence economy results into low taxable capacity since production is for own consumption and not for exchange therefore cannot easily be taxed while a highly commercialized economy leads to high taxable capacity since most of the output produced is for exchange, therefore higher incomes are easily taxed by government leading to a higher taxable capacity of the nation.

5. **The level of income distribution.** Fair income distribution leads to high taxable capacity since

majority of the people have some income for tax payment while unfair income distribution leads to low taxable capacity as majority of the people have less income thus unable thus unable to pay taxes.

6. **The tax rate.** High tax rates imposed on tax payers lead to high taxable capacity since individuals pay big sums of money in form of taxes while low tax rates imposed on tax payers for instance judges limit government from acquiring adequate revenue hence low taxable capacity.

7. **The level of prices/ cost of living.** High price levels lead to low taxable capacity since tax payers remain with fewer incomes after spending most of it on purchasing goods and services while low levels of prices enable people to pay for taxes without affecting their standard if living hence high taxable capacity.

8. **The level of tax exemptions to tax payers.** High level of tax exemptions especially to foreign investors who would otherwise be potential tax payers narrows the tax base hence low taxable capacity while low level of tax exemptions widen the tax base hence high taxable capacity.

9. **The political atmosphere.** A favourable political atmosphere enables smooth running of the production process leading to increased output and production of high quality goods hence high taxable capacity while unfavourable political climate destroys the existing infrastructure, puts tension on producers leading to low levels of quantity and quality of goods produced hence low taxable capacity.

10. **The skills of tax administrators.** Highly skilled tax administrators have the ability to carry out the tax assessment and administration process effectively thereby raising high levels of tax revenue and high taxable capacity while incompetent tax administrators end up harassing the tax payers and this makes people to hate tax payment hence low taxable capacity.

11. **The population size.** The bigger the population size, the higher the taxable capacity because there are many people whose incomes can be subjected to taxation while the smaller the population size, the lower the taxable capacity as there are few individuals whose incomes can be taxed.

12. The level of consumption/ consumption habits.

CAUSES OF LOW TAXABLE CAPACITY IN LDCS

- Low levels of income in the country.
- Poor identification of the tax bases/ sources
- Tax evasion and tax avoidance
- High levels of corruption and embezzlement of funds among tax officials/ low levels of accountability.
- Excessive tax exemptions to tax payers.
- Underdeveloped infrastructure
- High levels of income inequalities among the tax payers
- Existence of a large subsistence sector.
- Low tax rates on some tax payers.
- Political instability.
- Unskilled tax officials.

IMPACT AND INCIDENCE OF A TAX

IMPACT OF A TAX

Impact of a tax refers to the person or firm on whom a tax is officially/ initially levied.

OR

Is the first resting place of a tax.

INCIDENCE OF A TAX

Incidence of a tax refers to the person who ultimately bears the burden of the tax.

OR

Is the final resting place of a tax.

OR

Refers to how the real tax burden is shared.

The incidence of a tax can be shifted either backward or forward.

1. **Backward shifting of the tax.**

   This is where the tax payer shifts the tax burden to the previous party in the production process e.g. the producer shifting the tax burden to the supplier of raw – materials by paying low prices.

2. **Forward shifting of the tax.**

   This is where the tax payer shifts the tax burden to the next party in the distribution chain e.g. a retailer shifting the tax burden to the final consumer in form of increased prices for the commodities.

Incidence of a tax either falls on the producer or consumer or a combination of the two depending on the price elasticity of demand.

Case 1: Taxation and perfectly inelastic demand

CLASSIFICATION OF TAXES

Taxes can be classified according to;

a) Tax to income ratio (tax rates)

b) Tax incidence

CLASSIFICATION ACCORDING TO TAX TO INCOME RATIO (TAX RATES)

Tax rate refers to the proportion of income paid as a tax.

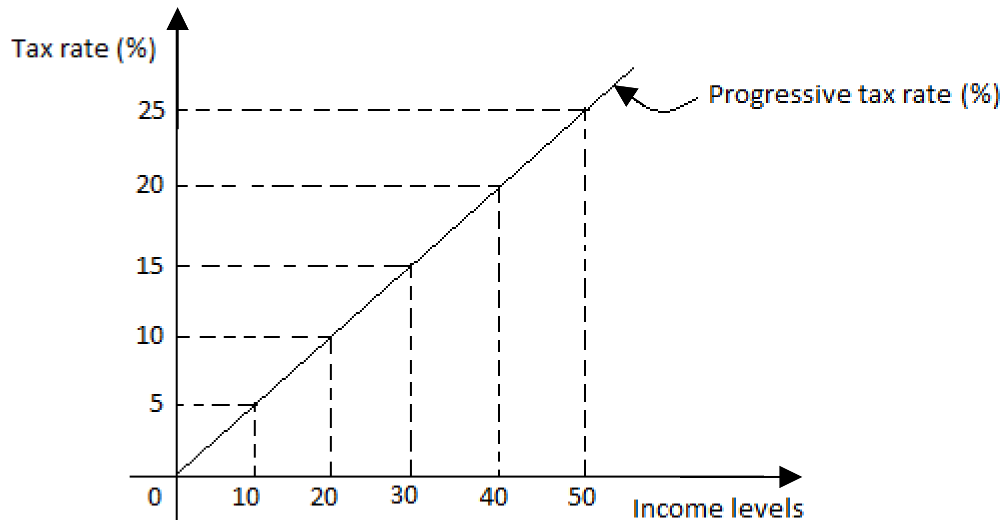
Categories of taxes according to tax rates include;

1. Progressive tax
2. Regressive tax
3. Proportional tax

PROGRESSIVE TAX

A progressive tax one whose rate increases with increase in the tax payer's income i.e. it takes a higher proportion of income of the rich than the poor.

Illustration



ADVANTAGES OF A PROGRESSIVE TAX

- It yields high tax revenue to the government.

- It promotes equitable distribution of income and wealth
- It favours low income earners
- Helps to fight demand pull inflation

DISADVANTAGES OF A PROGRESSIVE TAX

- It is a disincentive to work.
- It discourages savings
- It arouses resentment among the rich
- It tends to discourage investors.
- It encourages tax evasion and avoidance among the rich.

GUIDING QUESTIONS

a) Define the term progressive tax. (01 mark)

b) State any three effects if progressive taxes in an economy. (03 marks)

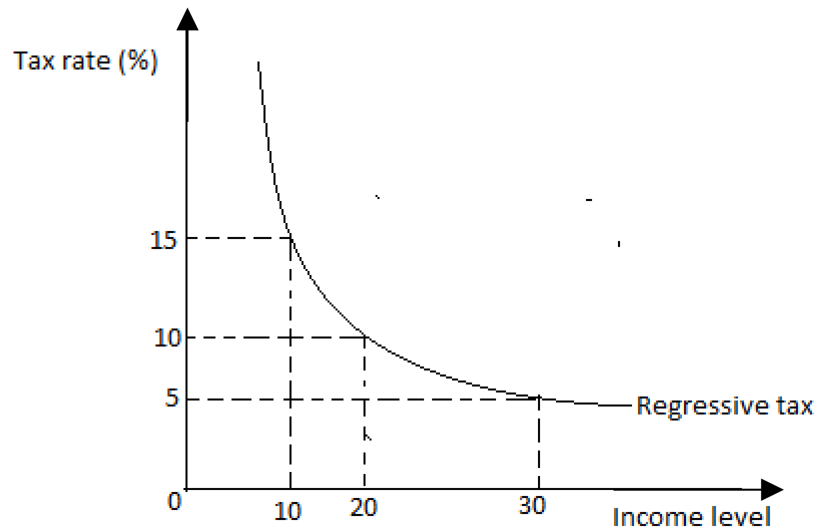
c) Give any four reasons for imposing a progressive tax. (04 marks)

d) Give any four advantages of a progressive tax over the proportional tax. (04 marks)

REGRESSIVE TAX

A regressive tax is one whose rate falls/ reduces as the tax payer's income increases i.e. it takes a higher proportion of income of low income earners than high income earners.

<u>Illustration</u>



ADVANTAGES

- It promotes savings and investment among the rich.
- It encourages hard work among the poor.
- It is associated with low rates of tax evasion and avoidance among the rich.
- It attracts foreign capital transfer by the rich especially from other countries which are charging higher taxes.

DISADVANTAGES

- It widens the <u>income gap</u> between the rich and the poor.
- It limits <u>consumption of mass</u> consumer goods/ it reduces the standards of living <u>among the poor.</u>
- Low revenue is realized by the government

- It discourages savings and investments among the low income earners (poor).
- It leads to social unrest/ political discontent.
- It encourages tax evasion and avoidance among the poor

GUIDING QUESTIONS

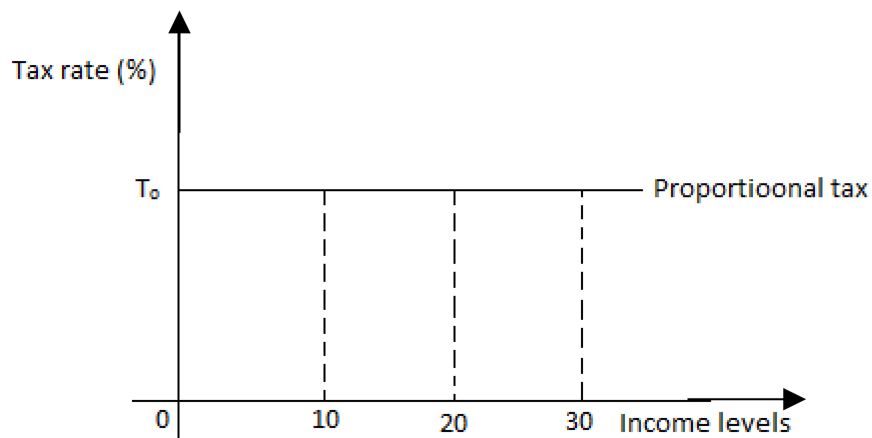
a) Define the term regressive tax. (01 mark)

b) State any three effects of regressive taxes in an economy (03 marks)

PROPORTIONAL TAX

A proportional tax is one whose rate remains constant at all income levels.

Illustration



ADVANTAGES

- It is simple for both the tax payer and the tax collector
- It does not discourage savings and investment

- It easy to calculate and thus the amount to be collected is easily predicted.
- It is a non-dusting tax because everyone knows how much to pay.

DISADVANTAGES

- It is inequitable because it favours the rich as compared to the low income earners.
- It does not generate enough government revenue as compared to the progressive tax.
- It does not confirm to the principle of taxable capacity (ability to pay) because it forces low income earners to sacrifice more than the rich.
- It reduces the standards of living among the poor because it takes a large proportion of their income.

CLASSIFICATION ACCORDING TO TAX INCIDENCE

In this case, we have direct and indirect taxes.

DIRECT TAXES

These are taxes that are imposed directly on individuals/ companies' income or wealth and cannot easily be shifted to another party.

TYPES OF DIRECT TAXES

1. **Income tax**

   This is a tax imposed on individual's/ firm's income.

   This tax is progressive in nature i.e. the rate increases as the tax payer's income increases.

2. **Death toll/ estate duty**

   This is the direct tax levied on the property of the deceased person before it is distributed to the beneficiaries.

3. **Inheritance tax**

This is the direct tax levied on property already acquired from a deceased person.

4. **Wealth tax**

This is the direct tax levied on wealth or past accumulated savings of a person.

This tax is mainly imposed to ensure equity of incomes.

5. **Land tax**

This is a direct tax imposed on land possessed by individuals mainly to discourage ownership of large chunks of land and to encourage development of cities and towns.

6. **Corporate/ company tax**

This is a direct tax `levied on profits of companies.

7. **Agriculture revenue tax**

This is a direct tax imposed on the agricultural produce realized as income by the farmers.

8. **Poll tax**

This is a direct tax of a fixed amount levied on every member of the male adult population regardless of the income earned by the tax payer.

9. **Sur tax**

This is a direct tax imposed on very high incomes exceeding certain limits as set by the tax authorities in a given country.

It is charged mainly to ensure equitable distribution of income.

10. **Capital gains tax**

This is a direct tax levied on financial assets whose value has increased from the time of their

purchase to the time of their sale.

ADVANTAGES OF DIRECT TAXES

1. **They promote equitable income distribution.** This is because they are progressive in nature hence affecting mainly the rich compared to the poor leading to reduction in income inequality with its associated negative consequences.

2. **They promote hard work among the people i.e.** regressive taxes encourage people to work hard since their rates keep on reducing as incomes increase.

3. **They help in controlling monopoly power with its negative consequences.**

4. **They influence resource allocation.** Government uses direct taxes when influencing allocation of resources in that for sectors that government wants to promote, no taxes are levied on their activities while for sectors and activities that government finds less desirable, high taxes are levied on them.

5. **Help to control inflation.** This is because during periods of high inflation, direct taxes are increased thereby reducing disposable income hence controlling aggregate demand leading to price stability.

6. **They arouse awareness among tax payers.** As people continue to pay direct taxes, they feel a heavier burden since part of their income is taken in form of taxes. They therefore put pressure on government to deliver better services such as provision of better medical facilities, better roads among others hence civil responsibility.

7. **They are certain.** Direct taxes satisfy the principle of certainty since the tax payer knows the amount to pay, when and where to pay the tax. For example salary workers pay income tax whenever they earn income.

8. **They are elastic/ flexible.** These taxes can be adjusted by the government depending on the prevailing economic conditions e.g. during periods of high inflation rates, these taxes can be increased to control aggregate demand and can be reduced during a recession to stimulate purchasing power hence promoting investment.

9. **They are convenient.** This is because they are collected during the appropriate time when the tax payer has earned income.

10. **They are economical i.**e. when the tax rates increase, the cost of collecting direct taxes remains the same.

11. **They are simple and easy to understand.** This is because they are levied directly on incomes and property of individuals and enterprises unlike indirect taxes which are hidden in prices of goods and services.

DISADVANTAGES

1. **Direct taxes are associated with high administrative costs** especially in rural areas where people are scattered and the infrastructure is poor.

2. **They tend to discourage savings and wealth accumulation.** This is because they take a big percentage of incomes of entrepreneurs.

3. **They reduce consumption** due to reduced disposable income hence reduced peoples' standards of living.

4. **They are discriminative** as those whose income is not known are not liable to payment.

5. **They are easily evaded** especially if they are too high and this leads to loss of state's revenue.

6. **They discourage and scare away foreign investors** and this negatively affects economic growth and development.

7. **They are difficult to assess equitably.** This is because they discriminate among tax payers since some people are exempted from paying those taxes like the children, unemployed, poor unlike indirect taxes that are paid by all people buying goods and services.

8. **They worsen income inequality i.e.** regressive taxes since they take a big proportion of income of low income earners compared to high income earners.

9. **They erode the popularity of the government in power.** This is because they make the tax payers to forego consumption and saving as part of their income is taken away by the state in

form of taxes making people to hate the current government as they look at it as being exploitative.

10. **They discourage effort and hard work.** This is because they are progressive in nature therefore the rate of paying taxes increases as incomes increase which makes people to put in less effort hence negatively affecting output and economic growth rate.

11. **They are inconvenient.** This is because direct taxes are paid in bigger amounts (lump sum) and in advance unlike indirect taxes where the tax payer pays in small amounts when buying goods and services.

12. **They lead to a fall in the taxable capacity of a nation in the long run.** This is because incomes that would have been saved and later be used to generate more incomes are taxed away by the state which limits the ability of tax payers to put up more businesses that would generate high taxes in the long run.

13. **They lead to resource diversion.** Producers change from highly taxed productive activities to non-productive ventures that are not taxed.

14. **They lead to inflation.** High direct taxes force workers to demand for higher wages which forces the producers to increase the prices of commodities to recover the increased cost of production hence cost push inflation.

INDIRECT TAXES/ CONSUMPTION TAXES

These are taxes imposed on goods and services and paid by people who associate with such goods and services.

Indirect taxes are generally convenient because they are only paid when spending occurs. They are also generally cheap since those taxes are deposited by the producers and sellers in banks and they are less felt since they are hidden in prices of goods traded therefore consumers pay for them unknowingly.

TYPES OF INDIRECT TAXES

1. **Advalorem tax**

This is an indirect tax levied on a good as a percentage of its value.

<u>OR</u>

Is an indirect tax levied on a good depending on its value.

This tax is mainly levied;

- To raise government revenue
- To fight corruption in tax administration
- To encourage proper book keeping hence efficiency in business management.
- They reduce costs of tax collection.
- To protect domestic firms
- To improve balance of payment position
- To encourage hard work
- To discourage demerit consumption

2. **Specific tax**

Is a tax imposed on each unit of output produced.

<u>OR</u>

Is (an indirect) tax levied as a fixed amount per unit of a commodity (irrespective of its value)

<u>OR</u>

Is one levied on a good depending on its quantity e.g. tax levied per tonne of sugar produced and sold.

3. **Sumptuary tax**

Is a tax levied on some consumer goods to discourage their consumption basing on moral, health and economic grounds.

4. **Customs duty**

This is an indirect tax imposed on imports and exports of a country.

OR

This is a tax imposed on movement of goods across national boundaries.

5. **Export duty**

This is an indirect tax levied on exports (goods and services leaving a country).

It is used to raise revenue for government and to discourage export of some goods especially essential goods so as to meet local market demand.

6. **Import duty**

This is an indirect tax levied on imports (goods and services entering a country). Import duty is mainly levied;

- To raise government
- To improve balance of payment position
- To protect domestic industries
- To control imported inflation
- To control importation of undesirable goods

7. **Excise duty**

This is an indirect tax imposed on goods that are locally produced.

8. **Sales tax**

This is an indirect tax imposed on retail's sales of the trader.

9. Octroi tax/ duty

This is an indirect tax levied on goods in transit from one state to another but have to go through the territory of another country. For example commodities from Japan through Kenya to Uganda are charged octroi duty by the Kenyan government.

This tax is mainly levied;

- To maintain roads on which imports and exports are transported
- To cater for security services given to goods while in transit

10. Value added tax (V.A.T)

Is a tax imposed on the increase in the value of a commodity at each stage of production.

Advantages of V.A.T

- It is difficult to evade
- It avoids double taxation
- It does no lead to shifting of resources to other sectors
- It leads to increased government revenue because it is comprehensive.
- It brings efficiency in business management since it encourages proper maintenance of books o accounts.
- It encourages exports since taxes on exports are refundable
- It reduces corruption since payment is through the bank
- It is economical in terms of administration and collection since taxes are collected by the producers and later deposited in banks on behalf of the tax authority.

Reasons why V.A.T is imposed

To…………

Demerits of V.A.T

- It is inflationary in nature since it is imposed at every production stage which makes producers to increase prices of final goods and services.
- It is difficult to understand by both the producers and consumers (violates the principle of simplicity)
- It is difficult to access because most traders do not keep proper records.
- It violates the principle of equity because both the rich and the poor are subjected to the same tax rate.
- It discourages production because it increases the costs of production.
- High rates of V.A.T may cause unemployment as it discourages production and investment.
- It is costly in terms of tax administration and tax education in form of seminars, radio programmes, etc.
- High rate of V.A.T scares away investors and this negatively affects output levels hence reduced pace of economic growth and development.
- It reduces the economic welfare of people as it reduces their real income in terms of the number of commodities purchased.
- V.A.T has loopholes during tax administration. Tax payers try to undervalue their commodities as a way of paying less tax.
- It is used by political opportunists to sabotage the government. This leads to political unrests and instabilities.

MERITS OF INDIRECT TAXES

1. **They yield high revenue to the government** because they are comprehensive i.e. they are

imposed on a variety of commodities.

2. **They are less evaded.** This is because they are levied on consumer goods and services and consumers cannot out rightly dodge them since sometimes consumption is unavoidable.

3. **They are convenient to the tax payer.** This is because the tax payer only pays when spending occurs and pays in small amounts.

4. **They are less harmful to effort and initiative.** This is because they are hidden in prices of goods and services and thus consumers pay for them unknowingly.

5. **They are economical in terms of collection.** This is because those taxes are collected by producers and sellers and then deposit them in banks on behalf of the tax authority.

6. **They are productive.** This is because they generate enough revenue to the government without negatively affecting production of goods and services in the economy.

7. **They are flexible/ elastic i.e.** they can easily be revised at short notice since they are imposed on goods and services.

8. **Help in correcting B.O.P problems.** This is achieved through increasing taxes on imports especially those that are luxurious making them expensive therefore becoming less affordable while reducing or abolishing taxes on exports making them very competitive in foreign markets thereby increasing the country's export earnings leading to improvement in the B.O.P position.

9. **They are neutral.** This is because they are imposed on goods and services therefore paid by all people irrespective of their status and income as long as they buy the taxed goods.

10. **They have less negative effects on savings as compared to direct taxes.**

11. **They are used to discourage consumption of harmful/ demerit goods.** This is done by imposing heavy taxes on such goods e.g. cigarettes making them very expensive hence less affordable thereby protecting consumer' health.

12. **They are used to protect domestic industries.** This is achieved through imposing heavy taxes on imports to make them very expensive hence less affordable thereby promoting locally

produced goods hence enabling domestic firms to grow.

13. **They can be used to check on imported inflation.** This is done by imposing heavy taxes on goods from countries experiencing inflation so as to discourage their importation.

14. **Help in reducing income inequality.** This is achieved by imposing heavy indirect taxes on luxury goods highly demanded by the rich to reduce their purchasing power while imposing lower taxes on necessity/ essential goods mainly consumed by low income earners.

DISADVANTAGES OF INDIRECT TAXES

1. **They promote income inequality** since they tend to be regressive as the rich and the poor pay the same taxes when they buy taxed goods without any form of price discrimination.

2. **They lead to inflation** because produces pass them onto consumers in form of high prices.

3. **They reduce the volume and benefits of trade.** Indirect taxes imposed on exports and imports interfere with free trade since they make them expensive making them less competitive thereby reducing the volume and benefits of international trade.

4. **They promote trade malpractices such as smuggling** leading to loss of government revenue.

5. **They discourage investments.** This is because as they are levied, they increase production costs thereby reducing the profit margins of the investors.

6. **They lead to misallocation of resources** whereby investors divert their resources from highly taxed economic activities which sometimes are more productive to non-productive activities that are less or non-taxed hence negatively affecting the growth of the economy.

7. **They lead to resentment of government/ lead to traders' unrest.** This is because those taxes make goods very expensive reducing their demand hence making traders and consumers resist government and sometimes making it unpopular.

8. **Lead to inefficiency among the local protected firms.** Every indirect tax imposed on competitive imports makes domestic firms to become less innovative due to reduced competition from foreign goods hence limiting them from expanding.

9. **Indirect taxes lead to reduced consumption** hence reduced consumers' welfare.

10. **They lead to increased costs of production** which results into production of poor quality goods.

GUIDING QUESTIONS

1. Distinguish between the following;

    a) Advalorem tax and specific tax (02 marks)

    b) Sumptuary tax and Advalorem tax (02 marks)

    c) Corporate tax and capital gains tax. (02 marks)

2. Give any four reasons why V.A.T is imposed. (04 marks)

3. State any four uses of Advalorem taxes. (04 marks)

4. a) Distinguish between direct and indirect taxes. (04 marks)

    b. Assess the impact of direct taxes in your country. (16 marks)

5. a) Explain the principles of taxation. (10 marks)

    b. Give reasons why developing countries prefer indirect taxes to direct taxes. (10 marks)

ASSIGNMENT

Why do most countries prefer indirect taxes to direct taxes?

Solution

NABETA SOLUTIONS JUNE 2014 QN 11C

REASONS FOR LEVYING DIFFERENT TAXES

1. **To raise enough revenue for the government.** Taxes are the major sources of government revenue locally and thus different taxes are levied to raise the much needed revenue by the government to meet her recurrent and development expenditure.

2. **To reduce income inequality.** This is achieved by imposing heavy taxes on the rich and low taxes on the poor. It is also achieved by imposing heavy taxes on luxury goods consumed by the rich and imposing low taxes on essential goods consumed by the poor.

3. **To protect domestic industries from unfair foreign competition.** This is achieved through imposing high taxes on imports similar to locally produced goods so as to make them more expensive and less affordable.

4. **To accelerate economic growth.** This is achieved by encouraging various investments in an economy through offering tax incentives to investors. This increases on the volume of output produced and the economy achieves economic growth.

5. **To control/ regulate monopoly.** Monopolists are controlled by imposing either a specific tax or a lump sum tax on their profits. These taxes force monopolists to devise efficient ways of producing so as to increase their profitability.

6. **To control inflation/ to attain price stability.** During inflationary periods, heavy income taxes are imposed so as to reduce peoples' disposable incomes. This reduces their purchasing power thereby reducing aggregate demand for goods and services hence controlling demand pull inflation.

7. **To improve balance of payment position of a country.** This is achieved by imposing high taxes on imports to make them more expensive so as to discourage their importation. Similarly, taxes are imposed on exports to make them more competitive in the foreign markets. This results into increased export earnings.

8. **To influence and regulate the level of exploitation of natural resources.** This is where various forms of taxes are used as a tool for efficient allocation of various resources in an economy e.g. heavy taxes are imposed on the most demanded resources so as to avoid their overuse. Similarly, socially desirable but less profitable activities are taxed less to encourage their use.

9. **To discourage production and consumption of undesirable goods.** This is achieved by imposing heavy taxes on such products to make them more expensive and hence less demanded. A reduction in demand for such products reduces their production.

10. **To force individuals to save.** Some forms of taxes are means of forced savings e.g. NSSF. This is where individuals' incomes are compulsorily transferred to the state for public sector investment.

11. **To create more employment opportunities.** This is achieved by imposing high taxes on imported products similar to locally produced products. This keeps domestic firms in operation thereby safeguarding peoples' employment opportunities. It is also achieved by subsidizing domestic firms with revenues generated from taxes.

12. **To promote balanced regional development** through taxing the developed areas to finance backward areas.

ROLE OF TAXATION

POSITIVE

- Raising of revenue for the government.
- Reduces income inequality/ redistribution of income.
- Improvement in B.O.P position/ reduction of B.O.P deficit.
- Influencing resource allocation
- Protection of domestic of firms
- Discouraging production and consumption of harmful products
- Control of monopoly powers
- Promoting hard work.
- Influencing the rate of economic growth
- Fighting inflation
- Discouraging dumping

NEAGTIVE

- Discouraging savings
- Discouraging investment
- Reduction in peoples welfare
- Discourages effort and initiate
- Encourages illegal activities e.g. smuggling
- Creates resentment
- Regressive taxes widen income inequality
- Reduces volume and benefits of trade.
- Leads to diversion of resources from highly taxed activities to non-productive ventures (resource misallocation)
- Indirect taxes are inflationary.
- Leads to increased cost of production.
- Breeds inefficiency in the protected firms.

PROBLEMS FACED BY TAX AUTHORITIES IN LDCS

1. **High level of tax evasion and avoidance by tax payers.** This is mainly due to lack of commitment by the tax officials and existence of loopholes in the tax law. This greatly reduces government tax revenue.
2. **Inadequate skilled manpower.** Some tax officials are incompetent and therefore they cannot effectively assess and administer taxes.
3. **Low taxable capacity.** This is due to low levels of income among people.
4. **Poor infrastructure.** Most of the rural areas are remote and therefore they are difficult to reach. This increases the costs of collecting taxes.

5. **High rate of corruption.** Many tax officials are corrupt and this makes the government to lose a lot of revenue which is much needed for development purposes.

6. **Political instability in some parts of the country.** Many potential investors are scarred and this greatly reduces the tax base hence limited government revenue.

7. **Resistance from the public against tax payments.** The majority of the population is not sensitized about the importance of paying taxes. In addition, some taxes are difficult to understand by different tax payers. This leads to high costs of education.

8. **Difficulty in identifying taxable sources.** It is difficult to identify taxable sources which do not arouse resentment among tax payers. This leads to narrow tax base hence low levels of tax revenue.

9. **Frequent changes in employment, contracts and residence.** This makes it hard for the tax administrators to keep truck with the tax payers.

10. **Narrow tax base.** This is due to widespread poverty as a result of majority of the people having no employments that give them stable incomes.

11. **High levels of inflation in the country.** This reduces the real value of nominal tax revenue which makes government planning and budgeting very difficult.

12. **Inadequate facilities such as computers and other materials required for tax collection and administration.** This makes the assessment process very difficult.

WAYS OF IMPROVING THE TAX REVENUE AND TAX COLLECTION IN LDCS

1. **Reduce/eliminate corruption.** The corrupt officials should be prosecuted in courts of law. This helps to minimize on the loss of government tax revenue.

2. **Sensitize the masses on the role of taxation.** There is need to sensitize people about the different types of taxes and the importance of paying taxes through seminars, workshops, radio programmes among others. This helps the masses to develop a culture of paying taxes.

3. **Develop a tax payer friendly system of collection.** This helps to reduce tax evasion.

4. **Adopt the principle of equity/ fair assessment of taxes.**

5. **Develop infrastructure especially roads in rural areas.** This helps to lower the transport costs hence reducing the costs of tax revenue collection.

6. **Using trained personnel to assess and collect taxes.** This helps to increase on the tax revenue collections.

7. **Improved implementation of the tax laws.** There is need to plug the loopholes in the tax laws by reviewing the existing laws and ensuring that the laws are fully implemented as a way of minimizing the tax revenue lost through tax evasion.

8. **Ensure political stability.** This is done by ensuring democratic governance in the country. In addition, peace talks with rebels can be emphasized as a way of creating peace in the country so as to promote investment hence widening the tax base.

9. **Putting in place the anti-smuggling unit.** This can reduce on the smuggling of commodities in and outside the country hence increasing tax revenue from imports and exports.

10. **Putting in place facilities required to facilitate tax assessment and collection e.g. computers and other logistics.** This can help to improve on the tax administration and collection.

11. **Proper and efficient allocation of tax revenue.** There is need for the government to properly and effectively use the tax revenue in order to provide the social services to the people. This encourages people to pay taxes.

12. **There is need to expand the industrial sector.** This is because industries have the potential to increase tax revenue as compared to other sectors like agriculture.

OTHER CONCEPTS USED IN TAXATION

1. **Tax evasion.**

   This refers to the deliberate refusal by the tax payer to pay the tax assessed on him and it is illegal.

   Reasons why people evade taxes

- Existence of low income levels.
- Unfair tax assessment by the tax authorities.
- Limited information about the importance of taxation.
- Discontent about provision of services by the government.
- Relaxed tax administration.
- High tax rates imposed especially on low income earners for the case of regressive taxes.
- Low level of accountability among tax officials/ high rates of corruption and embezzlement of funds by tax officials also discourage people from paying taxes.
- Desire by some producers or sellers to retail all the earnings from selling their output.
- Poor methods of tax collection by tax collectors such as use of threats, confiscating of tax payers' property, beating up of the tax payers among others. Such unfriendly methods make some tax payers to hate tax payment.
- Lack of support by some tax payers for the current government and therefore they evade taxes to sabotage government programmes.

Measures to minimize tax evasion

- Reduce or eliminate corruption
- Sensitize the masses on the role of taxation.
- Develop a tax payer friendly system of tax collection.
- Adopt the principle of equity/ fair assessment.
- Ensuring proper and effective use of taxes.
- Improving the implementation of tax laws.
- Train tax officials to effectively assess and collect taxes.

- Building up infrastructure.
- Ensuring political stability.

2. Tax avoidance

This refers to the tax payer's exploitation of the loopholes in the tax laws in order to pay little or no tax at all; it is legal.

3. Taxable income

This is the proportion of the tax payer's income that can be subjected to taxation.

4. Dead weight tax

This is a tax which when imposed discourages the economic activity on which it is levied from continuing.

5. Tax yield

This refers to the total amount of revenue raised from taxation less the cost of collecting taxes.

6. Tax threshold

This is the minimum amount of income which is not subjected to taxation.

7. Tax liability

This refers to the amount of money the tax payer is expected to pay as tax in a given time.

8. Tax havens

These are countries which offer very low tax rates as a way of attracting foreign investors.

9. Tax exemption

This is where the tax payer is relived from paying taxes by the tax authorities.

10. Marginal rate of a tax

This refers to the percentage of the additional income that is paid as tax.

$$M.R.T = \frac{\text{Increase in tax}}{\text{Increase in income}} \times 100$$

Example

Given that Nakato's income increased from Ug.shs 500,000 to Ug.shs 800,000 and his tax liability increased from shs 50,000 to 80,000; calculate her MRT

Solution

$$M.R.T = \frac{80{,}000 - 50{,}000}{800{,}000 - 500{,}000} \times 100$$

$$= 10\%$$

11. Average rate of a tax

This refers to the percentage of the tax payer's income paid as tax.

$$A.R.T = \frac{\text{Tax liability}}{\text{Income}} \times 100$$

Example

Given that Irene earns shs 3,000,000 per annum and her tax liability is shs 350,000; calculate her A.R.T.

Solution

$$A.R.T = \frac{350{,}000}{3{,}000{,}000} \times 100$$

$$= 11.67\%$$

PUBLIC/ NATIONAL DEBT (BORROWING)

This branch of public finance studies the causes and methods of public borrowing and public debt management.

Public debt

Is a debt incurred by the central government, local government and public corporations as a result of borrowing from within the country or from external sources.

OR

It is the total borrowing by the state, local authorities and public corporations.

National debt

National debt is the money owed by the state (central government) to the people and institutions within its borders or to foreigners excluding the debts of local authorities and public corporations.

TYPES OF PUBLIC DEBTS

1. **Reproductive/ productive debt**

   Is one which is obtained for the purchase of real assets which generate income for the repayment of the debt.

   OR

   Is that which is used to finance projects that bring in returns e.g. used to purchase individual inputs i.e. it is a self liquidating debt.

2. **Dead weight/ unproductive debt.**

   Is one with no corresponding assets e.g. debt incurred to finance a war or B.O.P deficits. The interest on principle and the repayment of the principle has to be paid from taxes and other sources of public revenue.

   OR

Is that which is used to cover unproductive expenditures e.g. buying of fire arms, buying expensive cars for MPs. It is a debt which is not self-liquidating.

3. **Floating/ marketable debt**

This is a short term debt usually for less than one year contracted by the government through the sale of government securities such as treasury bills.

4. **Funded debt**

Is a long term debt for which there is no date of repayment but the borrower keeps on paying annual interest on principal.

5. **Unfunded debt**

An unfunded debt is one where the redemption debt or date of repayment is well known.

6. **Voluntary debt**

This refers to a debt acquired by the central bank without any force.

7. **Compulsory debt**

This refers to a debt acquired by the central bank using force. This is where people are compelled/ forced to buy government securities.

8. **Internal debt**

This refers to a debt which is contracted from within the country e.g. by selling government securities to the public by the central bank.

9. **External debt**

This refers to a debt contracted from sources outside the country e.g. from friendly countries, multi-national agencies like IMF, World Bank, etc.

NOTE

a) Soft/ concessional loan

Is a loan extended to a borrower at a very low interest rate with a long redemption period.

b) Hard loan

Is a loan facility extended to the borrower at a very high interest rate with a short repayment period.

REASONS WHY COUNTRIES INCUR PUBLIC DEBTS

1. **To ease the burden of taxation on citizens in the short run.** This is because in the absence of borrowing, government resorts to taxing people more heavily so as to realize the desired revenue for public expenditure.

2. **To raise funds currently needed for public expenditure.**

3. **To finance B.O.P deficit in the short run.** In the even government receives low export earnings with high import expenditure, it necessitates government to borrow so as to realize the much needed revenue.

4. **To supplement tax revenue.** Countries incur public debts to supplement the little tax revenues collected due to low levels of taxable capacity mainly caused by widespread poverty in the country.

5. **To control inflation by reducing the amount of money in peoples' hands.** Government borrows internally to reduce on the amount of money in circulation which consequent results into reduction in aggregate demand for goods and services which checks on inflation in the country.

6. **To fill the savings – investment gap.** This is where government undertakes various forms of investments without massive savings. This is because the borrowed funds are subjected to investments.

7. **To handle the effects of calamities/ disasters.** This is where government borrows as a way of generating money to help victims of natural calamities such as victims of landslides, floods among others. This is because during natural calamities, it requires immediate funding which cannot be raised through taxation.

8. **To sustain the market by leaving citizens with adequate disposable income.** This is because internal borrowing does not affect one's disposable income and consumption levels. It leaves an individual with enough income to sustain his standard of living.

9. **To achieve and maintain a given level of employment.** This is where the government uses the borrowed funds to invest in productive activities that generate more employment opportunities thereby reducing on the unemployment rate.

10. **To repay former debts incurred.** This is where government borrows from a new source at a lower interest rate to repay an old debt which has reached maturity and therefore needs to be serviced.

11. **To fill the foreign exchange gap.** This is where the government borrows externally and accesses the scarce foreign currency which enables the country to buy goods it cannot produce from other countries. This is because other countries do not accept local currency but instead accept foreign currency.

DEMERITS OF PUBLIC DEBTS

1. **Promote/ worsen external dependence especially external borrowing** hence the country becomes more reliant on others.

2. **Exerts pressure on balance of payments.** This is because it involves heavy expenditures abroad in form of debt repayment.

3. **They limit capital accumulation and investments.** This is because money that would have been put aside for investment is instead used by the country to service debts acquired by the government.

4. **They may lead to inflation in case the government borrows from the central bank.** This is because when the government borrows from the central bank, money supply increases leading to an increase in aggregate demand in the economy hence demand pull inflation.

5. **Borrowing shifts the burden of repayment to the future generation.** The people who live later are disadvantaged because they have to contribute to repayment of a debt from which they have never benefitted.

6. **Public debts increase political and economic dominance in the economy.** This is because the lender influences social, economic and political status of the borrower.

7. **Borrowing increases income inequality.** This is true especially true when the borrowed funds are used to develop one region or misused through corruption to benefit a few individuals.

8. **Borrowing does not promote civil responsibility among citizens towards nation building.** This is because the citizens do not contribute towards government revenue and therefore are not concerned much about how government allocates the borrowed funds.

THE BURDEN OF PUBLIC DEBT

This refers to the negative effects that a nation or community undergoes to repay the public debt.

OR

It refers to the hardship citizens of the nation go through to repay the public debt.

The burden of a public debt is expressed in a number of ways;

1. The debt as a percentage of national income.

   This is given by $\frac{\text{Public Debt}}{\text{National income}} \times 100$

2. Debt as a percentage of total population.

   This is given by $\frac{\text{Public Debt}}{\text{Total population}} \times 100$

3. Debt as a percentage of labor employed

This is given by $\frac{\text{Public Debt}}{\text{Labour employed}} \times 100$

4. Debt as a percentage of imports

This is given by $\frac{\text{Public Debt}}{\text{Imports}} \times 100$

5. Debt as a percentage of foreign exchange earnings.

This is given by $\frac{\text{Public Debt}}{\text{Foreign exchange earnings}} \times 100$

6. Debt as a percentage of taxed revenue.

This is given by $\frac{\text{Public Debt}}{\text{Government tax revenue}} \times 100$

PUBLIC DEBT MANAGEMENT

This refers to the process of acquiring, utilizing, servicing and repayment of debts by the central authority or local authority or public corporation.

OBJECTIVES OF PUBLIC DEBT MANAGEMENT

- To mobilize financial resources
- To maintain price stability.
- To influence the rate of interest charged on the loan acquired.
- To influence income distribution/ control income inequality.
- To ensure proper utilization of funds/ to minimize or control corruption.
- To reduce the debt burden/ to minimize the cost of the public debt.

TERMS USED IN PUBLIC DEBT MANAGEMENT

1. **Debt contraction**

   This refers to the process of obtaining a loan/ debt from a lender. Debt contraction is formal especially if it is from external sources and both the lender and the borrower must sign a debt agreement.

2. **Periods/ years of grace**

   This refers to the time frame between debt contraction and the time when debt servicing starts.

3. **Debt servicing**

   This refers to the process of payment of interest on the principal sum of money borrowed and sometimes part of the money borrowed. Debt servicing begins after the period of grace has expired.

4. **Debt retirement**

   This is the time when the contacted debt must be repaid by the borrower and it takes place after debt servicing.

5. **Debt rescheduling**

   This is where the borrower negotiates with the lender to adjust the date of debt retirement and after that a new date must be stated for debt retirement.

6. **Debt cancellation**

   This is where the lender removes the debt burden of the borrower by writing off the debt.

7. **Debt repudiation**

   This is the outright denial of the debt liability where government refuses to honour the debt obligations.

8. **Sinking fund**

   This is the money put aside by the government in the budget with the aim of paying a debt.

9. **Debt conversion**

   This is where one form of debt is converted into another form e.g. converting a short term debt into a long term debt at lower interest rates.

WAYS OF CLEARING PUBLIC DEBTS (EXTERNAL DEBTS)

1. **Negotiating for debt cancellation i.e.** negotiating with the lender to remove the debt burden from the borrower by writing off the debt.
2. **Debt repudiation i.e.** outright denial of the debt where the government refuses to honour the debt obligations.
3. **Use of sinking fund i.e.** money set aside by the government in the budget with the aim of paying debts.
4. **Use of revenue from non-tax sources** such as fines, market dues, licenses and rates.
5. **Undertaking financial accommodation i.e.** printing of more money.
6. **Operation of surplus budget i.e.** ensuring that the planned government expenditure is less than the planned government revenue to secure some money for debt repayments.
7. **Disinvestment i.e.** sale of government property to obtain revenue to clear external debts.
8. **Borrowing from both internal and external sources to pay the old debt.** This works only if the borrowing conditions of the new debt are better than the conditions of the old debt.
9. **Debt rescheduling i.e.** negotiating for a new date for debt retirement hence postponing the burden of clearing the debt.
10. **Debt conversion i.**e. converting a short term loan into a long term loan with lower interest rates.
11. **Appealing for grants/ donations from foreign resources** that can be used to clear some debts.
12. **Use of accumulated profits from state owned enterprises** to clear some debts.
13. **Use of foreign exchange reserves in the central bank.**

14. Use of debt swap.

WAYS OF CLEARING INTERNAL DEBTS

1. **Use of sinking fund i.e.** money set aside by the government in the budget with the aim of paying debts.
2. **Increasing tax rates especially from wealth and high incomes** to obtain more revenue to clear debts.
3. **Use of surplus budget i.e.** one where planned government revenue is greater than planned government expenditure hence accumulating revenue to clear debts.
4. **Selling government securities i.e. bonds, treasury bills that have attractive interest rates on them** hence government being able to obtain revenue to clear old debts.
5. **Use of compulsory saving schemes** and part of the funds can be used to clear internal debts e.g. NSSF.

DEBT FINANCING VERSUS TAXATION FINANCING

Debt financing refers to where the government borrows to finance its expenditures that may not be covered by tax revenue.

Taxation financing refers to where the government uses revenue from taxes to finance its expenditures.

ADVANTAGES OF DEBT FINANCING OVER TAXATION FINANCING

1. Borrowing does not have negative political effects compared to taxes which may cost the government political popularity.
2. It is sometimes easier to borrow than to tax.
3. Borrowing helps to realize a lump sum of money unlike taxes where revenues come in

slowly. In other words, borrowing is a quicker way of raising revenue.

4. Borrowing supplements tax revenue that tends to be low due to a narrow tax base.
5. Through borrowing, government makes use of both domestic and foreign sources while taxation makes use of internal sources.
6. Borrowing does not have adverse effects on the economy compared to taxation which reduces disposable income.
7. Debt financing does not have methods of collection as compared to taxes.
8. Borrowing does not discourage consumption and investments as compared to taxes.
9. Borrowing does not raise the cost of production compared to taxes that cause inflation especially when indirect taxes are levied.
10. The debt burden can be shifted to the future generation in case of borrowing which is not the case with taxation.
11. Borrowing does not affect savings as compared to taxation.
12. Borrowing is more appropriate than taxation in case of political instability and other emergencies like earth quakes, floods, landslides, epidemics among others.
13. Borrowing improves on the country's relationship with other countries and international organizations like IMF and World Bank which is not the case with taxation.
14. Borrowing is associated with lower levels of corruption and embezzlement of funds compared to taxation.

PUBLIC EXPENDITURE

This branch of public finance is concerned with the ways in which government spends its revenue and its effect on social services such as health, education, etc.

Public expenditure refers to the total amount of money spent by the government on provision of social services and other development activities.

TYPES OF PUBLIC EXPENDITURE

1. **Recurrent/ consumption/ operating expenditure**

   Is the day-to-day spending of government aimed at maintaining existing capacities for example payment of wages, rent, interest on the national debt and periodic contributions to international organizations.

2. **Development/ capital expenditure**

   Is the expenditure by the government on establishment of projects for purposes of both expanding existing capacities and creating new ones to generate more goods and services for example expenditure on setting up medical centres, schools, roads and other forms of infrastructure.

REASONS FOR INCREASED PUBLIC EXPENDITURE IN UGANDA

1. Rising costs of infrastructural development.
2. Rising emergence funding due to frequency of natural hazards.
3. Rising levels of corruption and embezzlement of government funds.
4. Rising government expenditure due to increasing political/ social unrest.
5. Increasing expenditure on the settlement of the public debt.
6. Rising expenditure on international commitments/ engagements.
7. Continuous over ambitious planning.
8. High rate of inflation leading to rising costs of project implementation.
9. High population growth rate. Uganda is one of the countries with the highest population growth rate in the world. It is about 3.4% per annum. High population growth rates require massive investments in social and economic infrastructure like in education, health, transport and housing hence increased public expenditure.
10. Increase in administrative costs due to increasing size of public service, creation of new

district, frequent bi-elections, cabinet increases, etc.

11. Rising government expenditure on international programmes to provide job opportunities, income generation.

FISCAL POLICY

This is the deliberate policy under which government uses its expenditure and revenue (taxation) programmes to regulate the level of economic activities.

INSTRUMENTS OF FISCAL POLICY

- Taxation
- Government/ public borrowing.
- Government expenditure.

Other instruments used in Uganda include;

- Subsidization
- Debt repayment
- Privatization/ public disinvestment
- Licensing
- Fees
- Fines

OBJECTIVES OF FISCAL POLICY

1. To increase the rate of economic growth through influencing production levels.
2. To improve B.O.P position by discouraging imports and promoting exports.
3. To protect infant/ domestic industries by use of import duties.

4. To reduce income inequality by taxing the rich and subsidizing the poor.
5. To achieve balanced regional development by taxing already developed areas and increasing government expenditure in underdeveloped areas.
6. To discourage consumption of demerit goods through high taxation.
7. To ensure price stability through increased taxation and reduced government expenditure.
8. To influence investment levels through tax reliefs.
9. To improve incomes and quality of life of the population by increasing government expenditure on such services.
10. To raise government revenue through taxation.
11. To control monopoly through taxation/ subsidization of other firms.
12. To influence resource allocation through tax holiday/ reliefs.

THE NATIONAL BUDGET

The national budget refers to an estimate of the revenue government intends to raise and how it plans to spend that revenue in a given financial year.

OR

The national budget refers to planned government revenue and planned government expenditure in a financial year.

COMPONENTS OF THE NATIONAL BUDGET

The budget contains the following information;

- Review of the previous financial year's social economic performance of the country.
- The current size of GDP and GNP.
- The current economic growth rate of the country.

- The desired economic growth rate in the near future.
- The country's B.O.P position.
- The objectives of the current fiscal budget.
- The monetary and fiscal strategies for the year.
- The contribution of each sector of the economy to GDP/ National output e.g. agricultural sector, tourism, industrial sector, etc.
- The country's estimated revenue and expenditure of the next financial year.

THE SIGNIFICANCY (ROLE) OF THE NATIONAL BUDGET IN UGANDA

1. **Helps in creation of employment opportunities via increased investments.** This is achieved through increasing government expenditure on establishment of public sector projects that widen employment opportunities and also use part of the public revenue to provide loans for investments and tax incentives that attract more investors enabling them to establish businesses hence providing job opportunities to people.
2. **Helps in attaining and maintaining price stability.** This is achieved through increasing direct taxes on high income earners thereby controlling aggregate demand and also through using part of government revenue to provide subsidies that enable producers to increase supply of goods and services leading to a fall in prices.
3. **Helps in correction of B.O.P deficits.** This is achieved through tariffs on non-essential imports which discourages their importation and through subsidizing exporters thereby increasing the volume of exports leading to increased foreign exchange earnings.
4. **Helps in protection of infant industries.** This is achieved through imposition of tariffs and non-tariff barriers on competing imports which reduces their demand and also government uses the budget to avail subsidies to local industries enabling them to lower their average production cost.
5. **Reduces income inequality.** This is achieved through taxing the rich more heavily than the

poor and also through taxing heavily luxurious goods highly demanded by the rich and through granting soft loans to the low income earners to enable them participate in production hence earning income.

6. **Helps in discouraging consumption of harmful/ demerit/ undesirable products** by highly taxing them making them less affordable by consumers.

7. **Raises revenue for the government.** Through the budget, government comes up with various sources of public revenue such as taxation, licenses, fees, fines, borrowing, etc hence helping government meet her planned expenditure.

8. **Accelerates the rate of economic growth.** This is achieved through increasing government expenditure on establishment of productive infrastructure that attract production of more goods and services and also through availing more funds for subsidies that enable producers to expand their productive capacity leading to increased economic growth.

9. **Helps to stimulate investment rates** via use of a deficit budget hence lifting the economy out of a recession.

10. **Used to create balance in regional development.** This is achieved through increasing government expenditure on productive infrastructure in underdeveloped regions thereby stimulating economic activities that make those regions to develop.

11. **Helps to solicit for foreign aid.** The budget enables the government to indicate to the donors planned expenditure and planned revenue and how donor funds are going to be utilized hence inducing the donors to offer their support.

12. **Helps to redistribute resources from private to public sector.** This is achieved through taxing private individuals especially the rich and using their resources for public sector development.

13. **Helps in mobilization of the masses.**

14. **Helps in regulation of government expenditure.**

NOTE

For objectives, begin with “To”……………

TYPES/ CLASSIFICATION OF THE BUDGET

1. BALANCED BUDGET

Is one where estimated government revenue is equal to estimated government expenditure in a given financial year.

2. UNBALANCED BUDGET

Is one where the estimated government revenue is either greater or less than the estimated government expenditure in a given financial year.

Two situations arise out of an unbalanced budget i.e. surplus budget and deficit budget.

a) SURPLUS BUDGET

Is one where planned government revenue exceeds planned government expenditure in a given financial year.

OBJECTIVES OF A SURPLUS BUDGET/ REASONS WHY GOVERNMENT PLANS FOR A SURPLUS BUDGET

1. **To control inflation.** This is achieved by increasing direct taxes and reducing government expenditure especially on non-essential goods and services. This reduces purchasing power of the people hence controlling inflation.

2. **To accumulate funds for future use.** Through surplus budgeting especially as government increases direct taxes, it is able to obtain funds that it puts aside in the central bank and other banks to be used in future even for purposes that cannot be easily foreseen.

3. **To reduce/ regulate a boom.** This is achieved through increasing direct taxes and reducing government expenditure which helps to control peoples' purchasing power hence being able to maintain economic stability.

4. **To accumulate funds for financing development projects.** As government increases taxes on incomes while at the same time reducing its expenditure, a lot of funds are acquired that enable different development projects to be established since they require huge capital e.g.

construction of dams, bridges requires huge capital.

5. **To reduce aggregate demand.** A surplus budget increases taxes on incomes and reduces government expenditure especially on non-essential goods and services hence controlling aggregate demand and helping the economy overcome economic instabilities.

USES OF REVENUE FROM A SURPLUS BUDGET

1. Servicing public debts as well as retiring them
2. Accumulating government reserves that are used to finance deficit budgets and also cater for unforeseen circumstances (emergencies).
3. Used to give out investment loans to citizens to enhance creation of more employment opportunities.
4. Used to give grants and donations both locally and abroad.
5. Used to rehabilitate the existing infrastructure.

DISADVANTAGES OF A SURPLUS BUDGET

1. Reduces aggregate demand for goods and services hence reducing on consumption on consumption of goods and services leading to low standards of living.
2. It encourages over taxation in the economy thereby reducing consumption of goods and services which results into a fall in prices of goods and services hence reduced productivity.
3. Leads to a decline in investments and employment levels in the country.
4. Discourages government expenditure which reduces economic growth and development.

b) **DEFICIT BUDGET**

Is one where planned government revenue is less than planned government expenditure in a given financial year.

REASONS WHY GOVERNMENT DELIBERATELY PLANS FOR A DEFICIT BUDGET

1. **To improve peoples' standards of living.** This is done mainly through reducing taxes on incomes hence increasing peoples' purchasing power thereby stimulating aggregate demand and investments.

2. **To maintain high employment levels domestically.** This is achieved through reducing taxes on company profits and also increasing government expenditure by giving investors subsidies to enable them lower the costs of production and stay in business thereby maintaining the employment levels in the country.

3. **To undertake big ventures** that cannot be financed by taxation but by borrowing.

4. **To protect domestic infant industries** through giving them tax holidays.

5. **To avoid political resentment caused by high taxation rates.** This is because reducing taxes on incomes makes the government more popular and also increasing government expenditure on different activities enables people to acquire most of the basic needs of life.

6. **Tax revenues in Uganda (LDCs) are generally low** due to high poverty levels and limited commercialization of the economy amidst rising expenditure needs to support the growing population and demands of economic growth and development hence deficit budgeting.

7. **To pull an economy out of economic depression.** This is done by reducing taxes on incomes and increasing government expenditure which helps to boost aggregate demand and economic activities in general thereby helping the economy to recover.

8. **Due to fear of negative consequences of high taxes.** Taxation burdens tax payers since it takes a lot of their incomes hence government preferring to use other sources of revenue especially borrowing than to tax people.

9. **Borrowing is a faster method of raising revenue than taxation** and large sums of money are realized quickly to meet government expenditure instead of using taxation which is a slow method raising revenue hence planning for a deficit budget.

10. **To encourage savings.** Reduction in taxes enables individuals to put aside some money for

future use.

HOW GOVERNMENT FINANCES A DEFICIT BUDGET

The government finances a deficit budget through the following ways;

- Borrowing from external sources.
- Borrowing internally/ sale of government securities.
- Appealing for donations/ grants.
- Use of foreign reserves.
- Privatization.
- Printing of more money.
- Compulsory savings e.g. NSSF
- Levying special taxes.
- Organizing a national lottery.

DISADVANTAGES OF A DEFICIT BUDGET

1. **Leads to inflation.** This is because it makes the government to spend heavily yet it involves tax reductions on incomes leading to excessive aggregate demand without corresponding increase in the level of output produced.
2. **Leads to balance of payments of problems.** This is because government has to continuously borrow externally to cover the desired expenditure hence repaying and servicing of loans which leads to heavy expenditure by government abroad causing B.O.P problems.
3. **Leads to failure by government to finance some vital development projects.** This is because sometimes government fails to source loans and grants in time yet tax revenues are low limiting growth of the economy.
4. **Worsens problems of economic dependence.** This is because government sometimes fails to

acquire resources internally thereby being forced to borrow externally or appeal for grants/ donations from other countries and international agencies. This leads to negative consequences associated with economic dependence e.g domination of the economy by foreigners.

NOTE

Deficit financing refers to a deliberate government measure aimed at reducing the level of government revenue by reducing taxation while maintaining or increasing expenditure.

CAUSES OF PERSISTENT BUDGET DEFICITS IN LDCS

1. **Narrow tax base.** LDCs like Uganda have few economic activities on which taxes are levied therefore receive low tax revenue yet government expenditure needs are ever rising leading to deficits.

2. **High degree of tax evasion and avoidance due to a number of reasons such as widespread poverty, discontent about the services offered by government among others.** This leads to low tax revenue realized in relation to rising government expenditure leading to deficits.

3. **Low taxable capacity.** Many people in LDCs have extremely low incomes therefore are unable to pay taxes and remain with enough disposable income to enable them continue enjoying the same standard of living they are accustomed to hence making government realize less revenue to meet government expenditure needs causing budget deficits.

4. **Poor tax administration and management.** Some tax officials have limited skills of collecting taxes and identifying tax sources where taxes are levied hence resulting into low tax revenue realized in relation to rising government expenditure leading to deficits.

5. **High rate of corruption and embezzlement which is evident in mismanagement of public funds.** Government officials swindle government revenue while other officials ever budget beyond the funds required to implement the government budget leading to increased planned government expenditure hence deficits.

6. **High administrative expenditures on politicians and civil servants** due to large size of the public service, establishment of new districts, frequent elections, large cabinet and large

parliament leading to heavy expenditure to support administration, payment of wages and allowances yet sources remain very low.

7. **Heavy public debt burden and servicing.** Developing countries borrow both internally and externally to meet both the recurrent and development expenditure. This calls for heavy government repayment obligation and servicing debts yet some debts are not self-liquidating.

8. **Excessive military expenditure due to political unrests which disrupt production.** LDCs like Uganda face a number of political unrests which leads to heavy expenditure by government on military hardware and big army to fight rebels and riots hence leading to heavy expenditure.

9. **Over ambitious planning i.e. planning beyond the means.** Government engages in very many projects beyond what it can handle such as power generation, providing free education at all levels, recruiting many civil servants etc. such projects lead to heavy government expenditure.

10. **Frequency of natural hazards/ disasters that require heavy emergence funding such as earthquakes, floods, landslides which destroy property and lives.** Therefore a lot of relief funds are needed to support the victims especially to cater for foods, medical care and shelter leading to heavy government expenditure than revenue.

11. **High costs of infrastructural development such as establishment of hospitals, roads, schools, power generations in order to meet both the needs of the growing population and economic growth.** Such infrastructures require a lot of funds to be set up and maintained hence causing heavy government expenditure far beyond revenues.

12. **Heavy expenditure on external commitments e.g.** contributions to international organizations such as COMESA, E.A.C, O.A.U, UN leading to heavy government expenditure in relation to planned revenue.

13. **Increasing government expenditure on programmes to create employment opportunities e.g. youth fund, teachers' SACCOs, loans for science students among others.** All those programmes take a lot of government money in form of expenditure than what government receives in form of revenue hence deficits.

14. **Limited non-tax sources of revenue.** The government has fewer areas where revenues other than taxation are collected e.g. fees, fines, market dues hence government finding it difficult to raise adequate revenue yet government expenditure continues to increase causing deficits.

15. **Etc.**

MEASURES TO MINIMISE BUDGETARY DEFICITS IN LDCs

1. **Encouraging cost sharing in the provision of services i.e.** sharing of costs between government and beneficiaries of government services like education, medical care among others so that the burden of expenditure is shared between government and those using the services hence government being able to cut down on its expenditure thereby controlling budgetary deficits.

2. **Stabilize the political situation.** This can be done through negotiation with political opponents and rebels. This helps to reduce government expenditure on defense and also helps to stimulate productive economic activities where taxes are levied leading to increase in government revenue.

3. **Decentralization of power/ government.** The central government should empower local authorities like districts, municipalities and town councils to devise different sources to come up and finance their areas instead of relying only on the central government for survival hence leading to reduction in government expenditure.

4. **Further privatization of state enterprises.** Government should continue to transfer ownership of state enterprises to private individuals. This enables government to acquire more revenue necessary for meeting government expenditures and also helps to reduce government expenditure on supporting those enterprises especially through subsidization.

5. **Fight corruption in state departments.** This should be done through strengthening institutions to fight corruption. This helps to minimize embezzlement of state revenue and also reduce government expenditure through employing officials to fight corruption and even government officials who tend to over budget beyond the funds required for project implementation.

6. **Increase non-tax sources of revenue other than borrowing e.g. fundraising, fees charged on services provided by government, market dues, special assessment, etc.** This helps to increase government revenue thereby reducing budgetary deficits.

7. **Restructure and rationalize foreign missions and other government commitments.** Government should reduce on unnecessary frequent free travels by government officials, withdraw them from some of the international engagements especially those that are unproductive by merging, closing some embassies hence helping to reduce government expenditure on such international commitments thereby reducing budget deficits.

8. **Control population growth rate.** This should be done mainly through encouraging use of planning methods both scientific and artificial. This helps to reduce government expenditure on provision of social services such as schools, hospitals, etc hence minimizing budget deficits.

9. **Avoid dead weight debts/ reduce acquisition of unproductive debts.** All efforts should be made to avoid acquiring such debts that do not help to generate more income for the government since such debts lead to heavy expenditure by government on servicing and repaying them yet do not generate income for the state.

10. **Retrenchment of public service/ reduction in administrative costs.** This should be done through reducing on the number of civil servants especially those that are aging and are unproductive, merging some districts, reducing on the number of MPs and ministers hence helping to reduce government expenditure on various issues like paying wages and other allowances.

11. **Further liberalization of the economy.** Government should continue removing unnecessary restrictions on production and trade. This attracts more investors that participate in various productive activities enabling government to raise its revenue through taxation hence minimizing budget deficits.

12. **Widen tax bases especially through supporting diversification of the economy e.**g. through provision of tax incentives and subsidies to various investors in different sectors like industry, trade, agriculture, etc such that there are very many sources where taxes can easily be levied

hence leading to increase in government revenue to facilitate government expenditure.

13. **Improve on tax collection.** This can be done through using trained personnel to assess and collect taxes, developing a tax payer friendly system of collection, sensitizing masses on the role of taxation, etc. All this increases on the tax revenue thus minimizing budget deficits.

14. **Etc.**