

PUBLIC FINANCE

Public finance refers to a branch of economics which studies how the government raises revenue and how such revenue is spent to achieve stated social and economic goals in a country.

Composition of public finance

- a) Public revenue
- b) Public expenditure
- c) Financial administration such as government budget, auditing
- d) Fiscal policy
- e) Public borrowing/debts

Functions/positive roles of public finance

- 1) Influences the level of investment in the economy. Lower taxes imposed on investment accompanied by increase in government expenditure increases the investment levels in the economy.
- 2) Reduces disparities in the distribution of income in the country. This is through progressive taxes where high income earners are taxed higher rates than the low income earners.
- 3) Raises government revenue for meeting recurrent and development expenditure. This is through direct and indirect taxes imposed by government among others.
- 4) Through fiscal tools, it controls the consumption of undesirable products. This is by imposing high taxes on such products like cigarettes, alcohol, to discourage people from buying them.
- 5) Determines /influences the level of employment in the economy. This is done by reducing taxes on investment and increasing government expenditure to promote production and employment creation.
- 6) Improving the balance of payment position of a country. This is through imposing high taxes on imported goods, hence reducing the volume of imports and the country's expenditure abroad.
- 7) Regulates economic situation that is, controls inflation or deflation in the economy. This is through adjusting direct taxes on incomes which influences the disposable income and aggregate demand.
- 8) Protects local industries and domestic producers from foreign competitors. High taxes imposed on imports discourage importation of such commodities and this widens the domestic market for local producers.
- 9) Accelerates the rate of economic growth in the country. This is through imposing lower taxes on investments, which promotes investment and production leading increase in output and economic growth.
- 10) Regulates foreign investment and general capital inflow in the economy.
- 11) Influences allocation of resources in the country.
- 12) Controls monopoly power in the economy.

Sources of public revenue

Public revenue is the total income of the state or government from all sources. There are two (2) major sources of public revenue:

(a) Tax revenue

(b) Non-tax revenue.

Non-tax revenue

Refers to all the sources of government revenue other than taxes. These include the following:

- 1) **Fees.** This refers to money paid by individuals against any direct service rendered by the government to them. Such as a fee for weighing one's vehicle, valuing one's property, school fees in public schools and universities, company registration among others.
- 2) **Licenses.** A license is a document that gives permission/authorizes an individual or a company to conduct business or carry out any meaningful activity (such as road license, import license, trade license, and driver's license). The payment made to government to secure a license is a source of government revenue.
- 3) **Fines/ penalties.** Refers compulsory payments imposed on individuals who do not abide by laws of the government. Or compulsory payments to curb certain offences such as failure to pay tax, court fines, reckless driving or traffic offences.
- 4) **Compulsory savings schemes** such insurance policies, NSSF (national social security fund)
- 5) **Floating government securities.** This involves government selling securities to the public such as treasury bills, bonds. The government uses this money until maturity period for paying back to security holders comes.
- 6) **Special assessment.** Refers to the amount of money that the government charges for a specific purpose such as charging residents a certain amount to establish a school, a health centre, a water point.
- 7) **Income or profits raised from public enterprises** or parastatals i.e. government owned companies. *(However the current economic trend of privatization is reducing this source of revenue).*
- 8) **Gifts, donations and grants.** Money received by government which does not form part of exchange. Or contributions made by individuals, agencies, governments of other countries to a particular country in order to enable the recipient country to meet its development needs.
- 9) **Deficit financing.** This is where government depends on borrowing (from internal and external sources) to finance its' recurrent and development expenditures. *(It can also be by printing and minting more money).*
- 10) **National lotteries/ gambling.** The amount of money government receives from gambling usually in form of national lotteries also acts as government revenue such as jada, premier in Uganda.
- 11) **Sale of public assets and enterprises.** The government can sell out the public companies or parastatals to raise revenue.
- 12) **Rent from property within and abroad.**
- 13) **Public fundraising.**

- 14) *Forfeitures.** Refers to money paid by individuals to government for specific purposes which money will never be recovered or refunded.

TAX REVENUE

Taxation is the process of assessing, collecting and administering taxes. Taxation is the main source of government revenue and this revenue is received through direct and indirect taxes.

A tax refers to a compulsory (a legal payment) contribution imposed by government on goods and services, incomes and wealth of individuals and companies (*to raise revenue for public use*).

A tax is a non-quid pro quo compulsory payment to government. It is a non-quid pro quo transfer payment because a tax payer does not expect to receive a definite and direct return of services or goods from government (*it is not value-for-value payment*).

Why government needs revenue from taxation? / Reasons for imposing taxes

1. ***To raise revenue for the government.*** The different forms of taxes (direct and indirect taxes) raise money for financing the government expenditure (as follows):
 - For administration and enforcement of security, law and order i.e. there is need to pay the army, police, prisons, civil service, and other government departments.
 - To provide social services such as health/medical care, roads, education services, sanitation services, power, transport services.
 - Need to provide relief during disaster for the poor or affected people, needy, disabled, and such other people.
 - Need to finance state-owned enterprises like public corporations or parastatals.
 - Need to finance development projects such as research schemes, industrialization projects etc. the government meets its recurrent and development budget.

Other reasons for taxation other than raising revenue

2. ***To control inflation (inflationary pressures) in the country.*** High direct taxes reduce the disposable income, thereby checking on excessive demand/ purchasing power of goods and services.
3. ***To reduce income inequalities / to re-distribute incomes in the country.*** Progressive taxation is a tool for equitable distribution of income and wealth—since the rich are charged higher interest rates than the poor. This reduces the gap between the rich and the poor.
4. ***To discourage the consumption of harmful or undesirable goods*** in the country such as cigarettes, spirits, pornographic materials. High taxes imposed on such goods raise their prices and hence discourage/reduce their consumption.
5. ***To Correct balance of payment disequilibrium especially B.O.P deficit/ to reduce BOP deficit.*** High import duties check on excessive consumption of imports and hence reducing the country's expenditure abroad.
6. ***To protect the country's local infant industries.*** This is by imposing import duties on imported commodities that compete with those produced by the local infant industries.

7. ***To control monopoly power in the country.*** This is by imposing lump sum, specific taxes and profit taxes on the monopoly firms in the country. These taxes reduce the abnormal profits enjoyed by monopolists and thus reduce their dominance of the market.
8. ***To influence the allocation of resources in the economy.*** Government imposes high taxes on the non-priority areas or sectors and imposing lower taxes (tax holidays or tax exemptions) on priority or desired areas—where investment is encouraged.
9. ****To influence the level of investment in the country.*** Taxation acts as an incentive to increased savings and investments. High taxes lead to a reduction in the level of investment while low taxes encourage investment in the country.
10. ***To create financial self-reliance of the economy*** instead of deficit financing (borrowing) especially from foreign sources (countries and agencies). This is also because borrowing is attached to high interest rates and debt burden.
11. ***To promote individual responsibility/hard work and self –reliance among citizens.*** Because they are required to pay taxes; they work hard for more hours to maintain or improve their standard of living; and also question how their money is being spent.
12. ****To protect the environment and control negative externalities.***

Roles of taxation (Positive roles of taxation)

- Influencing resource allocation
- Means of raising public revenue
- Improving the country's BOP position
- Controlling inflation
- Regulating monopoly power
- Discouraging consumption of undesirable commodities
- Accelerating the rate of economic growth
- Protecting domestic firms
- Ensuring a more equitable distribution of income
- Encouraging investment

Qn. Under what circumstances might the instrument of taxation be used other than for raising revenue?

Or under what circumstances can tax be used besides raising revenue?

1. When curbing/controlling inflation.
2. When controlling monopoly power, by lump sum and specific tax.
3. When aiming at equitable income distribution
4. When aiming at self-sustainability of the economy and correcting balance of payment position.
5. When protecting infant industries.
6. When discouraging consumption of harmful products such as cocaine, cigarettes.
7. When re-distributing resources for balanced regional development.
8. When controlling population growth rate; by charging big families high taxes.

Negative effects of taxation

1. **High taxation leads to inflationary situation in the country.** High indirect taxes raise the cost of production, causing high prices for the commodities. They also cause pressure for raising wages leading to inflationary pressures.
2. **Heavy taxation results into illegal activities** like smuggling due high import duties; unrest, riots and strikes making government unpopular. This is because some groups resent the taxes and develop a negative attitude towards tax collectors and the government in power.
3. **Taxation discourages investment.** High taxation on investments reduces profitability to investors. This accelerates the rate of capital flight to foreign countries where taxes are relatively low.
4. **Heavy taxation Leads to diversion of resources to non-essential/ less important activities** where taxes are low. The heavy taxes on some goods discourage their consumption and hence reduced production.
5. **Worsens poverty levels and reduces people's welfare.** High taxes reduce disposable income and this lowers the purchasing power of people. This in turn leads to low standards of living and widespread poverty.
6. **Taxes reduce the level of savings in the country.** Very high taxes have a net effect of reducing the level of savings in the country and thus low rate of capital formation. Some money that would be saved is paid as tax.
7. **Taxes discourage initiative and hard work.** This mainly applies to the progressive taxes where the burden falls more on the high-income earners.
8. **Proportional and regressive taxes increase income inequality.** These taxes heavily affect the low-income earners and favour high-income earners.
9. **Taxes discourage international trade (reduce the volume and thus the benefits of trade).** For example, high import duties reduce the flow of imports into the country, and this reduces the benefits from trade.

Principles of taxation/ canons of taxation

Canons of taxation (*maxims of taxation*) refer to the basic rules upon which a tax system is built to achieve its objectives. OR these are the qualities of a good tax system which must be followed in tax assessment and collection.

Adam smith advanced four (4) principles/ canons o taxation.

1. **Equity/ fairness.** A tax should establish economic justice. All tax payers should bear approximately equal burden. Each tax payer should contribute in proportion to his ability to pay or wealth so that there is equitable income distribution. There should be:
 - (a) **Horizontal equity.** This means that people in the same income bracket (and circumstances) should pay the same tax rate.
 - (b) **Vertical equity.** This means that people of different income brackets/ levels should also pay different tax rates.

2. **Certainty.** The tax payer should be aware or sure of the amount to pay, mode of payment and when to pay. This ensures harmony between tax payer and tax collection officials/ tax administrators.
3. **Convenience.** The tax should be payable at a time, place and mode of payment conducive to the tax payer. For example salary earners should pay at the end of the month and farmers should pay during harvest (*consider availability of income and convenient installments, nearness to the tax payer*).
4. **Economy/cheapness/efficiency.** The cost of tax assessment, collection and administration should be as low as possible. It should not exceed 5% of the tax collections. (*Expenses of collecting data, assessing tax payers, paying wages/salaries to tax collectors, printing receipts and forms, bank charges, and tax education should be low*).

However Other/more principles have been added to those of Adam Smith as below:

5. **Productivity.** (*Productivity of a tax is its ability to achieve the purpose for which it is intended such as raising revenue*). The tax should be able to raise enough revenue to the government and should not have adverse effects on productivity of the economy through over taxation. The government should be able to establish how much revenue a particular tax will yield and the rate at which the tax will be flowing in.
6. **Elasticity/ Flexibility or buoyancy.** The government should be able to increase or decrease the tax rates according to economic requirements and policy changes such as high tax during economic boom than during recession. [The taxes should be increased or reduced according to the changes in income levels of tax payers. As the national income increases, the share of taxation in national income should also increase].
7. **Simplicity.** The tax should be simple, straight forward and easy to understand by both the tax payers and tax collectors. It should also be easy to calculate to avoid disputes and evasion.
8. **Optimality.** The tax system should strike a balance between the amount of tax revenue collected and social services rendered to the public through government expenditure.
9. **Neutrality/impartiality.** The tax system should not have adverse effects on the allocation of resources. It should minimize the distortions on the relative prices. [A good tax system should not discriminate among the tax payers].
10. **Diversity/comprehensiveness.** A good tax system should have a variety of taxes. This ensures a stable and steady flow of tax revenue into the treasury. This also widens the tax base and re-distributes the tax burden to different groups and sectors.
11. ***Avoidance of double taxation.** A tax payer should not be taxed more than once on the same tax base.
12. ***Consistency.** A good tax should be in line with and encourage the achievement of desired economic objectives in the country.
13. ***Acceptability.** A good tax should be socially, economically and politically acceptable. This depends largely on the level of tax education. When people perceive a tax as oppressive /unjust, there is resentment against the tax and makes the government unpopular.

*Characteristics of a good tax system

Basic concepts/terms under taxation

1. **Taxable capacity.** Refers to the extent to which a tax payer can pay tax assessed on him and yet remain with enough disposable income to sustain him and his family in a given standard of living.
[Refers to the extent to which a tax payer is able to pay a tax assessed on him and remain with enough (disposable) to enable him live a decent life to which he is accustomed/ to live a reasonable standard of living. Or it is the maximum tax that the tax payer can afford and any additional taxation produces negative effects such as tax evasion, closure of business unit/firm]
 - **Taxable capacity of a nation.** Refers to the ability of a nation to raise the expected revenue through taxation without resulting into socially, economically and politically harmful effects.
2. **Taxable income**
 Refers to the amount of income which is subject to taxation.
[Or Refers to the proportion of an individual's income that is subject to tax after the tax—free allowances have been deducted].
3. **Tax base.**
 Refers to an item or activity on which a tax can be imposed /levied to raise revenue. Or it is the range of commodities, wealth, income or economic activities on which taxes are levied (in order to raise revenue).
4. **Tax avoidance.** This is where the tax payer exploits the loopholes or weaknesses in the tax system (or tax laws) not to pay tax or to pay less. Tax avoidance is legal and allowed e.g. refusing to buy a commodity on which tax has been imposed or changing business location.
5. **Tax evasion.** Refers to the deliberate refusal of a tax payer to pay tax assessed/imposed on him (by use of illegal means). The tax payer uses illegal means of dodging or reducing the tax payable such as under-declaring the value of his goods, hiding from the tax collectors, and smuggling goods to avoid check points.
6. **Tax liability.** Refers to the amount a tax payer (*a tax paying unit*) is expected to pay in a given period of time.
7. **Tax rebate.** Refers to the amount refunded to a tax payer by the tax authority, if the tax payer had paid more than he was supposed to pay. OR refers to a tax reduction under special considerations.
8. **Tax threshold.** Refers to the minimum amount of money income that is subject to tax. *[OR refers to the amount of money or level of income from which the tax liability begins. E.g. in Uganda the threshold of PAYE is shs 230,000 per month].*
9. **Taxation potential.** Refers to the measure of the nation's ability to raise revenue through taxation as determined by the country's productive resources on which taxes can be imposed.
 A country with abundant resources has a high taxation potential but if these resources are not exploited, then a country cannot raise enough revenue implying that the potential is not fully exploited.
10. **Tax holiday.** Refers to a period of time of non tax payment given by the government to reduce consumer spending and encourage investment spending.
11. **Impact of a tax.** Refers to the first point of contact of a tax or the initial/first resting place of tax.
[refers to a firm of person on whom a tax is initially levied It is upon those people with the first responsibility to pay tax to the authorities].
12. **Incidence of a tax.** Refers to the final resting place of a tax. *[OR refers to a person who ultimately bears the burden of a tax]* It is where the money burden of a tax ultimately or eventually falls.

For example the incidence of an indirect tax rests on the final consumer of the good.

13. **Tax haven.** This is when an economy or country deliberately reduces the tax rates in order to attract foreign investments.
14. **Tax yield.** Refers to the total amount of tax revenue collected from a given tax, given the number of taxes etc
15. **Average rate of a tax.** Refers to the proportion of income of an individual which is paid as tax.

$$ART = \frac{\text{Tax}}{\text{Income}}$$

16. **Marginal rate of a tax.** Refers to the rate of taxation on extra unit of income earned.

$$MRT = \frac{\text{Change in taxation}}{\text{Change in income}}$$

CLASSIFICATION OF TAXES

Classification according to tax rates (equity/percentage of income)

Tax rate refers the percentage of income of an individual which is paid as tax.

Under this category we have the following:

1. Progressive taxes.
2. Proportional taxes
3. Regressive taxes

Progressive taxes

Refers to a tax where the tax rate increases as the income of the tax payer increases.

[Or a tax where the tax rate increases with increase in income of the tax payer. In other words people with higher incomes pay a bigger percentage of their income].

Advantages of a progressive tax

- Promotes equitable distribution of income and wealth/ reduces income inequalities
- Yields more revenue to the government (it is very productive)
- Favours low income earners
- Helps to check/control demand pull inflation
- Controls monopoly power

Disadvantages of progressive tax

- Discourages hard work and effort
- Results into tax evasion by high income earners/ arouses resentment among the high income earners
- Discourage investment
- Reduces savings
- Creates resentment
- Reduces aggregate demand/ consumption/ welfare

For progressive taxes, the burden falls more on the high income earners compared to low income earners.

Proportional taxes (*flat taxes*)

Refers to a tax where the tax rate is constant for all income levels.

The same percentage of tax is paid by all the tax payers/ the tax rate remains constant irrespective of the level of income. The tax hurts more the poor whose disposable income reduces.

Regressive taxes

Refers to a tax where the tax rate reduces as the income of the tax payer increases.

In other words the low income earners pay a bigger percentage of their income as tax compared to the high income earners.

Positive effects

- Encourages hard work and effort
- Encourages savings and investment.

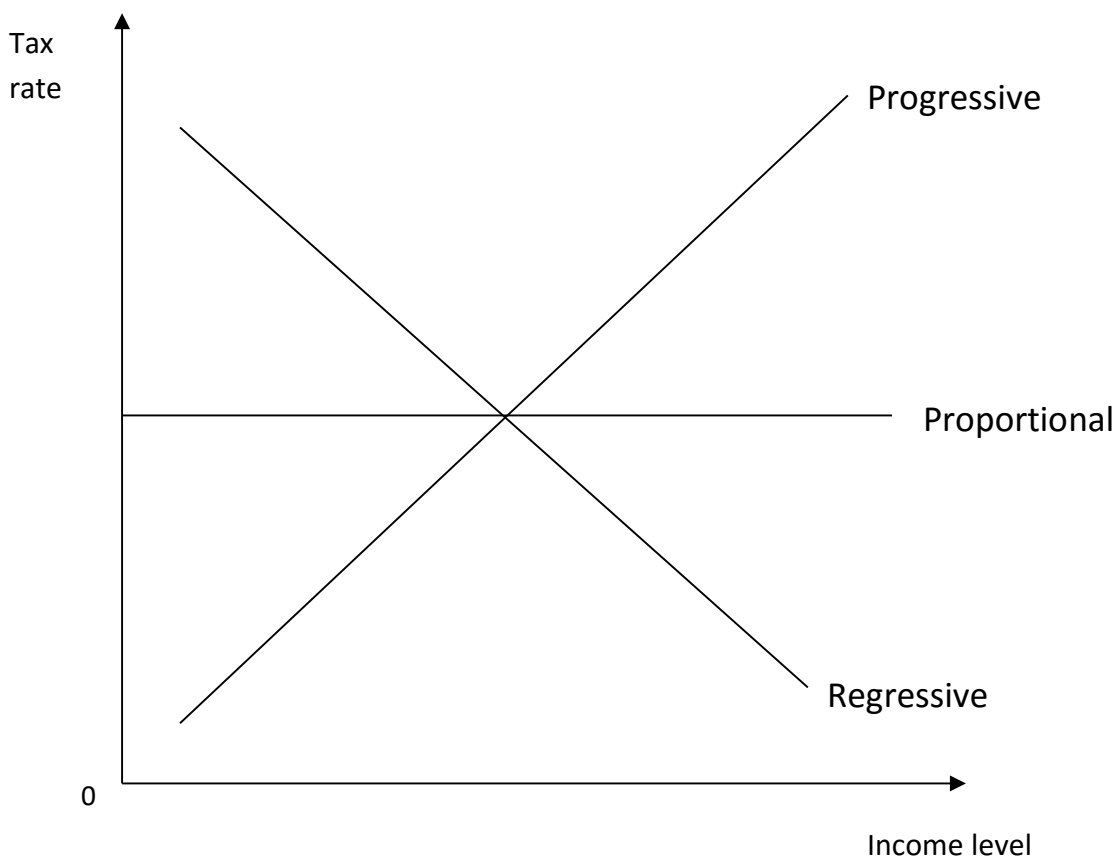
Negative effects

- Leads to low revenue realized due to tax avoidance
- Low income earners are subjected to poor standards of living
- Increases income inequality in the country (since it falls more heavily on the low income earners).
- Creates social tension between the rich and the poor
- Makes the government in power unpopular (since the majority poor see it as unfair)
- Reduces consumption of goods and services by the poor

Hypothetical table of proportional, progressive and regressive tax

Income level (shs)	Tax rate (%)		
	Progressive tax	Proportional tax	Regressive tax
10,000	10	15	20
20,000	15	15	15
30,000	20	15	12
40,000	26	15	8

Illustration of progressive, proportional and regressive tax



***Classification according to units of output taxed**

Under this we have:

1. A specific tax

Refers to a tax imposed per unit of the tax base. Or refers to tax imposed per unit of output. It is therefore a variable cost to a monopolist.

2. *Lumpsum tax

Refers to a fixed amount imposed as tax irrespective of the level of output. It is a tax imposed on a monopolist regardless of the level of output produced. It is regarded as a fixed cost to a monopolist.

3. Advalorem tax

Refers to a tax imposed as percentage of the value of the commodity / tax base. The higher the value of the good, the higher the advalorem tax.

According to incidence of tax

Taxes are majorly classified as:

- Direct taxes
- Indirect taxes

Direct taxes

Refers to taxes levied/ imposed on the incomes and property or wealth of individuals, and companies/firms and their incidence cannot be shifted to another tax payer. The incidence of tax rests on the same tax payer and cannot be shifted to another person.

Main forms of direct taxes

1) Income tax

Refers to a tax imposed on an individual's income. It is a tax levied on all types of income such as rent, interest, wages/salary, profits (above a certain level). Examples are PAYE—pay as you earn, graduated tax

2) Graduated tax

Refers to a tax imposed on all persons above a certain age excluding fulltime students, housewives and military personnel. It is tax levied on the basis of a person's income, property and land holdings.

3) Local service tax

This was introduced in Uganda to replace graduated tax and it is imposed on all individuals in meaningful employment.

4) Capital gains tax

Refers to a tax imposed by a seller of a capital asset whose value has appreciated between the time of purchase and the time of sale.

Note: A capital gain arises when the value of a capital asset goes up and it is realized when the asset is sold.

5) Company tax (corporate tax)

Refers to a tax levied on profits of a company (and other trading organizations' profits).

6) Estates duty/ death duty

Refers to a tax levied on the property of a deceased person (dead person), if such property exceeds a certain level.

7) Gift tax

Refers to tax imposed on gifts received by one individual from another.

8) Sur tax

Refers to a tax imposed or payable on very high incomes exceeding a certain specified amount. Therefore it is a progressive income tax.

9) Wealth tax/ property tax

This is a tax on the stock of past accumulated wealth of an individual. Or a tax levied on an individual's wealth. The value of the person's wealth, both financial and real assets is considered. The major demerit of this tax is that it discourages accumulation of wealth for fear of losing too much.

10) Poll tax(per capita tax/ capitation tax)

This is a tax imposed at a fixed rate on every head of the family irrespective of the income earned. It is regressive in nature. *(Some countries adjust their taxes to reflect the income levels of the tax payers and hence called graduated tax)*

11) Inheritance tax

This is tax imposed on an individual who has inherited wealth.

12) Capital levy

Refers to a special tax levied on the rich to finance emergencies like war, famine, floods and earthquakes.

Or it is a once and for all tax which is in most cases imposed when there is a national emergency situation such as war and government needs money to finance it or when there is need for much capital for development purpose etc

13) Land tax

Refers to tax imposed on landlords due to ownership of land especially in urban areas. It is intended to reduce monopoly of land by a few landlords.

14) Stamp duty/ transfer tax

Refers to tax payable on financial contracts i.e. payable on legal transfer of ownership of property.

15) Petroleum levy/tax

Refers to tax levied on petroleum products.

Advantages of direct taxes

1. **Direct taxes reduce income inequality in the country.** They are mostly progressive in nature (the rich pay higher tax rate than the poor) and this helps in equitable distribution of income and wealth.
2. **Direct taxes have a simplicity principle/ direct taxes are simple to understand and calculate by both the tax payer and the collectors.** The tax payer knows with certainty the amount he is expected to pay, when, how and where to pay (such as a percentage of the tax payer's income).
3. **Direct taxes are more convenient to the tax payer.** This is because they are collected at a time or season when the tax payers have received enough earnings such as PAYE (direct taxes are also spread over a long period, with a defined amount deducted from their earnings per month).
4. **Direct taxes are economical in that the cost of collection is low** especially among government employees. For example PAYE is collected by the employers directly from people's incomes and they remit it to the government.

5. ***Direct taxes control inflationary tendencies in the economy/It is a very effective tool against inflation.*** This is because they reduce the disposable income, hence reducing aggregate demand for goods and services in an economy.
6. ***The government is in position to exempt those who are unable to pay or a certain category of people*** such as women, the old, disabled, the unemployed, and students.
7. ***Direct taxes also create a sense of (civic) responsibility among the tax payers,*** since they are directly affected. They get concerned about the state's use of their taxes and thus checking on government expenditure.
8. ***Direct taxes are flexible, hence easily increased or decreased.*** They change according to economic requirements in the country. Therefore the government easily uses direct taxes to influence the level of economic activity.
9. ***Direct taxes encourage hard work among people.*** This is because people have to work harder to obtain money for paying the taxes as well as having a balance for survival.
10. ***Direct taxes are more certain in terms of revenue to be collected.*** Direct taxes are certain and predictable in terms of expected revenue per year, and this is useful for government planning. (The revenue from direct taxes is relatively stable over a long period).
11. Direct taxes generate revenue to the government which revenue is used to finance the recurrent and development expenditures of the country.
12. Direct taxes control monopoly power such as lumpsum tax and profit taxes imposed on monopoly firms.
13. The impact and incidence of the tax can easily be determined; hence the government can use it to achieve a desired goal.

Disadvantages of direct taxes

1. ***Direct taxes reduce on the level of savings of individuals*** such as PAYE. This because the taxes reduce the disposable income and less is saved.
2. ***Direct taxes reduce the level of investment in the economy.*** This due to the fact that they reduce aggregate demand since they reduce the disposable income. (*more so direct taxes are disincentive to work/innovation and invention since some people fear taxation*)
3. ***They reduce people's standards of living / welfare.*** This is because after paying the direct taxes people are left with less money for purchasing goods and services, hence reducing consumption (*high company taxes may also be translated into low wages and less benefits to workers*).
4. ***Some direct taxes are easy to evade (or avoid by tax payers)*** such as difficulty in understanding one's income. Some people can conceal their incomes they get from other sources and yet other tax payers do not stay in one place. This also makes assessment and collection complicated.
5. ***Direct taxes are discriminative in nature.*** Some categories of people such as low income earners, old age, relatives and friends of the tax assessors and collectors are either lowly assessed or favoured ---which is unfair.
6. ***Encourage capital outflow (capital flight) and discourages capital inflow.*** This is because foreign investors fear the taxes such as high company/corporate tax.

7. **Direct taxes are inconvenient to the tax payer.** This is because they are usually paid in lumpsum and in advance, and thus difficult to pay. Also the fact that they are paid by individuals directly is an inconvenience itself.
8. **Direct taxes create resentment by the people** towards the tax assessors, collectors and government in power. This is because they paid directly and hence easily noticed by the tax payer (*unlike indirect taxes which are hidden*).
9. **The costs of assessment and collection are high** when the tax payers are scattered in different places. The assessors need to go to the people, hence raising the costs and making some direct taxes uneconomical.
10. **It is very difficult to measure the taxable capacity of the people to determine how much income tax they have to pay.** There is either over taxation or under taxation.
11. Due to low taxable capacity in most developing countries such as due to high levels of unemployment and large subsistence sector limited amounts of revenue are always collected from direct taxes. This is because incomes are very low.
12. *Diversion of resources from highly taxed but productive to non-productive ventures that are not taxed or taxed less.

Indirect taxes (Outlay taxes/ Hidden tax)

Refers to taxes imposed on goods and services and their incidence can be shifted to another tax payer/person.

Indirect taxes are sometimes called hidden taxes, expenditure taxes, outlays or commodity taxes.

Indirect tax are referred to as **expenditure tax** because the tax authorities collect them from the sellers who possibly pass the burden on to the consumers by including the tax in the final price and receive the tax as consumers spend on such commodities.

Indirect taxes are also referred to as **outlay taxes** because an outlay is total expenditure on currently produced consumer goods and services or consumption and real capital.

Indirect taxes are paid indirectly to the government through the business people and other intermediaries.

Forms/types of indirect taxes

1. Customs duty

Refers to tax imposed on imports or exports of a country. It is a tax imposed on goods moving inwards or outwards across a country's borders. They are divided into:

(a) Import duty

This is a tax imposed on imports of a country; to raise revenue or to check on the consumption of imported goods (to boost infant industries).

(b) Export duty

This is a tax imposed on a country's exports; to raise revenue or to check on exports.

2. Excise duty

This is tax imposed on domestic imposed on selected domestically produced goods and services whether meant for exports or local consumption. This is imposed on goods like beer, spirits, wines, soft drinks, cigarettes, airtime, cement, fuel, sugar.

3. *Sales tax/ turn over tax

This is a tax imposed on all commodities sold within the country irrespective of whether the goods have been produced locally or imported. OR It is a tax imposed on sales of goods and services in the country. It is usually collected at whole sale level or retail level.

4. *Commercial transactions levy (CTL)

This is a tax imposed on services rendered daily to the public such as in hotels, restaurants, bookshops.

5. Octoroi tax

This is tax imposed on goods passing through a territory of another country /state. Or It is a tax on goods in transit to a given country but being transported through the territory of another country.

6. Sumptuary tax.

Refer to tax imposed on specific consumer goods to discourage their consumption. It is usually imposed on commodities such as cigarettes, alcohol, etc

7. Value added tax (VAT)

Refers to tax imposed on value added to a commodity at each stage of production. It is a modern broad based consumption tax paid by consumers and collected throughout the consumption and distribution change. In Uganda it is charged at a rate of 18%. However there are some commodities that are not charged VAT.

Advantages of indirect taxes

1. **Indirect taxes are very difficult to evade unlike direct taxes.** This is because they are contained in the prices of commodities and cover a wide range of commodities.
2. **They are economical to collect/they involve low costs of collection on part of the tax authorities.** This is because they are usually collected by business people and other intermediaries and then remitted to the tax authorities.
3. **Indirect taxes are convenient to the tax payer.** This is because they are hidden taxes and the tax payer pays since without noticing whenever they buy a commodity (also not paid in the lumpsum and they are paid when one has money to spend)
4. **They promote effort and hard work among nationals.** Indirect taxes result into higher prices and therefore consumers must work harder to earn more income to meet the high prices and maintain the usual standard of living.
5. **Indirect taxes are more flexible.** They are easily varied (increased or reduced) to meet the desired objectives or goals of the state according to changing economic conditions i.e. can be reviewed in the shortest possible time.
6. **Indirect taxes are impartial / they do not discriminate among the tax payers.** This is because they are paid by all consumers of goods and services (the high and low income earners).

7. ***Indirect taxes widen the tax base because of wide coverage/ they raise more revenue for the government.*** They are levied on a variety of commodities/ goods and services, hence diversifying sources of government revenue. (*They are comprehensive in nature*).
8. ***They guide in resource allocation in the country.*** The government uses the indirect taxes to influence production and consumption of different goods and services. High indirect taxes they are used to discourage non-priority areas/ sectors.
9. ***Indirect taxes protect domestic industries.*** This is by imposing high taxes on imported goods and thus reducing excessive competition from imports of goods which are produced by the local industries.
10. ***Indirect taxes are used to restrict or limit consumption of harmful commodities by the government.*** For example by imposing high taxes on cigarettes, pornographics, and wines to discourage their consumption.
11. ***Indirect taxes do not cause a lot of resentment and unpopularity of the tax collectors and government*** unlike direct taxes. This is because the public pay unknowingly.
12. Indirect taxes are employed to stabilize the economy such as imposing taxes on imported goods, excessive importation can be avoided and local producers are protected.
13. It is convenient to the government in that it gives it quick source of revenue and throughout the fiscal year.

Disadvantages of indirect taxes

1. ****Indirect taxes lead to increase in income inequality.*** This is because they are regressive in nature as both the high and low income earners pay the same amount of indirect taxes when buying the commodities.
2. ***Indirect taxes are regressive in nature.*** The poor and the rich pay the same amount especially on essential consumer goods (such as fuel, salt, and sugar), hence the poor are hurt more because they pay a bigger percentage of their incomes than the rich.
3. ***They tend to be inflationary in an economy.*** Indirect taxes force prices of commodities to increase causing inflation. Indirect taxes also lead to increased cost of production such as those imposed on inputs or raw materials—causing cost push inflation.
4. ***Indirect taxes lead to trade malpractices*** such as smuggling of commodities out and into the country especially very high taxes which traders try to dodge.
5. ***It is difficult to predict/ estimate the revenue to be collected under indirect taxes.*** Because they are not compulsory, the consumers and producers easily decide to abandon the highly taxed commodities and activities —hence loss of tax revenue. This makes planning difficult.
6. ***Indirect taxes cause diversion in resource allocation/ misallocation of resources in an economy.*** Resources are taken away from productive areas that are highly taxed to unproductive areas/ undesirable commodities where taxes are lower.
7. ***Indirect taxes reduce the volume and benefits of trade.*** They interfere with the free international trade being advocated for in the modern world especially import duty and export duty. (For example import duty reduces the amount of commodities imported into the country).

8. **Indirect taxes sometimes discourage production and investments in the economy.** High indirect taxes discourage investors and accelerate capital flight. This is due to falling aggregate demand.
9. **They reduce the economic welfare / standard of living in the economy.** This is especially on the side of the poor who cannot cope-up with the increase in price of some commodities. Higher prices caused by indirect taxes reduce the amount of commodities that consumers buy or they resort to buying poor quality lowly taxed commodities (*More so the more you consume the more indirect taxes you pay*).
10. **Indirect taxes result into traders' unrests and demonstrations and associated disadvantages.**
11. Indirect taxes lead to exploitation of consumers by producers/ sellers. The producers/ sellers take advantage of the increase in taxes to increase prices more than the increase in tax. Some indirect taxes are difficult to understand such as VAT.
12. They result into inefficiency within the protected firms i.e. local infant industries protected by the use of import duties always remain infant and inefficient.

Qn . Assess the impact of indirect taxes on the economy of your country

Positive impact

- Protects infant/domestic firms or industries
- Promotes effort/hard work of the people in the economy
- Discourages consumption of harmful commodities
- Influences resource allocation
- Improves the balance of payment position
- Provides government revenue

Negative impact

- Undermines the volume and benefits of trade
- Tends to be regressive/ promotes income inequality
- Results into reduced consumption, hence reduced welfare
- Promotes trade malpractices such as smuggling
- Tends to be inflationary/ leads to cost push inflation
- Leads to resentment of government/ leads to traders' unrest
- Discourages investment and production
- Leads to misallocation of resources
- Increases the cost of production
- Results into inefficiency in the protected firms/ protected firms tend to remain infant

INCIDENCE OF EXPENDITURE

Incidence of a tax refers to the final resting place of a tax or refers to the person who ultimately bears the money burden of a tax. [For a direct tax, the incidence of the tax is always on the person or firm on which the tax has been imposed. The incidence of the tax cannot be shifted. However, for indirect taxes

the incidence of tax can be shifted from the person or firm on which it has been imposed to another such as from the manufacturer /producer to the consumer].

The incidence of tax and the burden can be shared between the producer / seller and the consumer. The incidence of a tax (amount that will be paid) depends on the elasticity of demand and price elasticity of supply of the commodity.

Note:

- **Tax shifting**—refers to the transfer of part or the whole tax from the original taxpayer to another.
- **Forward shifting of a tax**—is where the tax imposed on a producer or seller is transferred to the buyers of the firm's products, by making them to pay higher prices for those products.
- **Back ward shifting of a tax**—is where the tax imposed on a firm/producer is transferred to the suppliers of the firm's inputs through paying them lower prices for those inputs.

After paying the tax, the individual suffers with the burden of the tax and the burden is of two major forms:

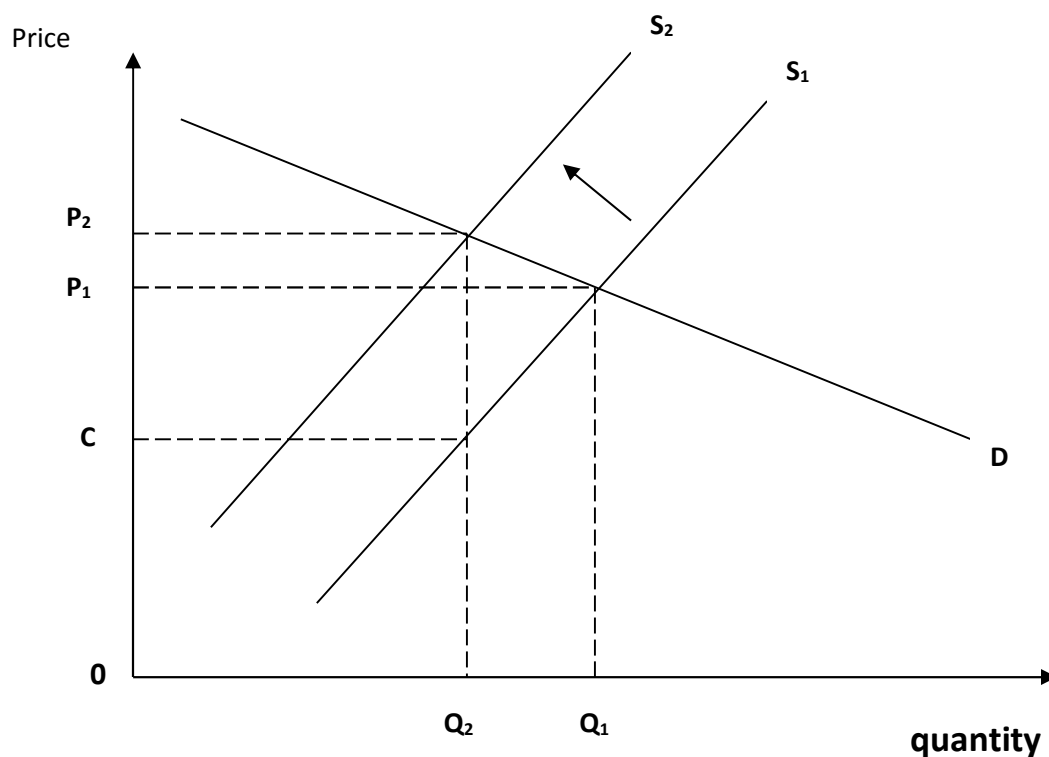
- (i) *Money burden of a tax*—this is in form of money lost by an individual through paying the tax.
- (ii) *Real burden of the tax*—this is in form of suffering or sacrifice through reduced consumption of the individual after payment of tax.

Effect of PED on tax incidence (Relationship between PED and tax incidence)

The tax incidence is shared between the producer and the consumer depending on the PED.

1) Where the demand for a commodity is elastic

A bigger portion of the tax is paid by the producer/seller and a smaller portion is paid by the consumer.



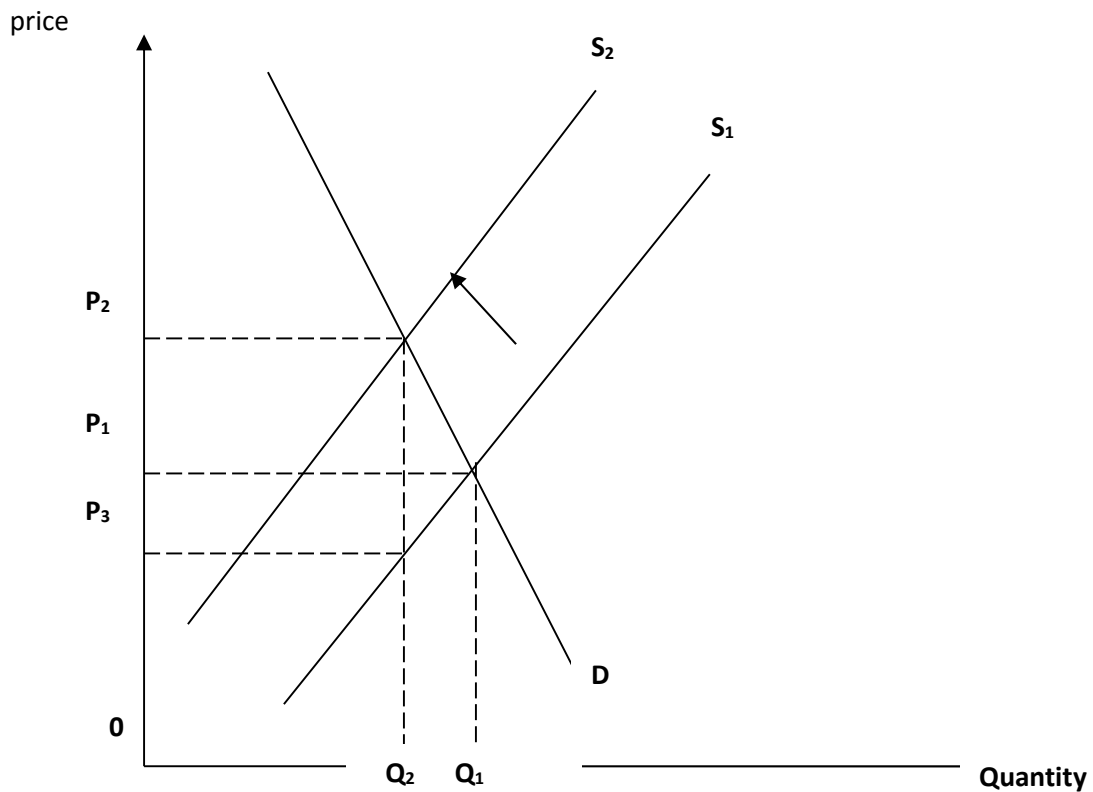
Area $P_2 DGE$ represents the total amount of tax. The consumer pays a smaller portion of the tax, which is represented by area $P_2 P_1 FE$, and the producer/seller pays a bigger portion of tax represented by area $P_1 DGF$.

Note: Before the tax is imposed on the producer, the consumer pays a price OP_1 and purchased an amount OQ_1 . Because a tax discourages production and supply of a commodity. Then supply of a commodity reduces and the supply curve shifts to the left from S_1 to S_2 due to the imposition of a tax. The consumer also pays a higher price OP_2 after the tax.

[The vertical distance between the supply curves represents the amount of tax imposed on each unit of a commodity].

2) Where the demand for a commodity is inelastic

A bigger portion of the tax is paid by the consumer /buyer, and a smaller portion is paid by the producer/seller.

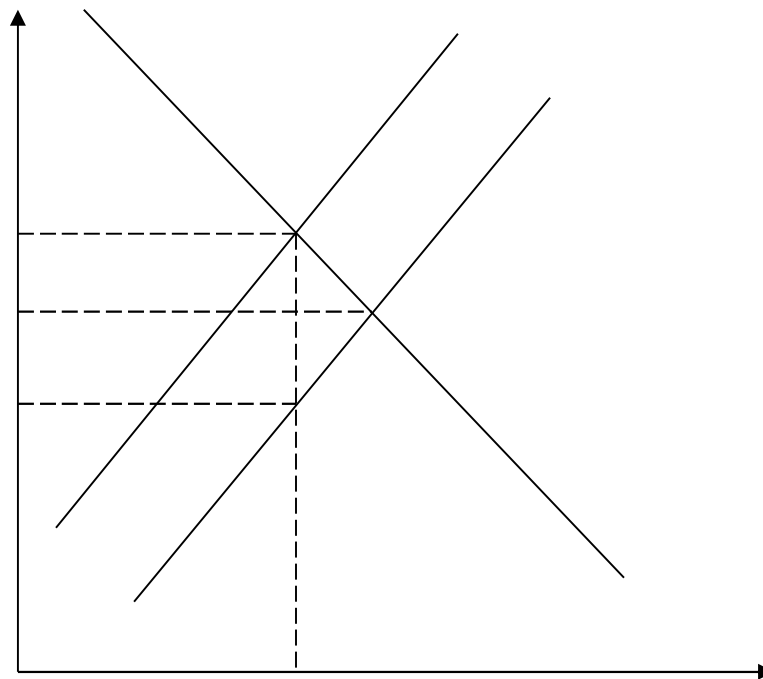


Before the tax, the equilibrium price is P_1 and the equilibrium quantity is Q_1 . The tax shifts the supply curve to the left and the price increases to P_2 yet the quantity reduces to Q_2 .

The total tax revenue from the tax is P_2P_3db . The consumer bears a bigger portion of the tax P_2P_1 , while the producer bears a smaller portion of the tax P_1P_3 . This is because the demand is inelastic.

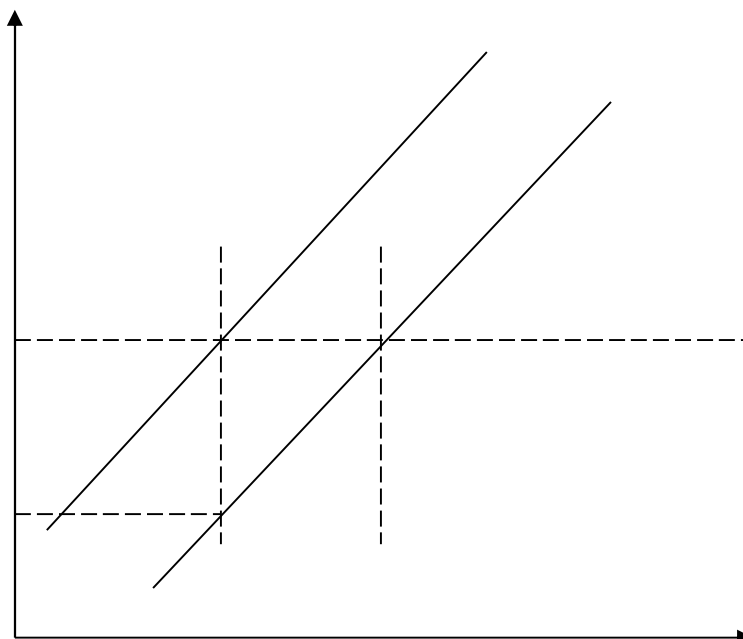
3) Where the demand for a commodity is unit elastic

The tax is shared equally between the producer/seller and the consumer.



4) Where the demand for a commodity is perfectly elastic

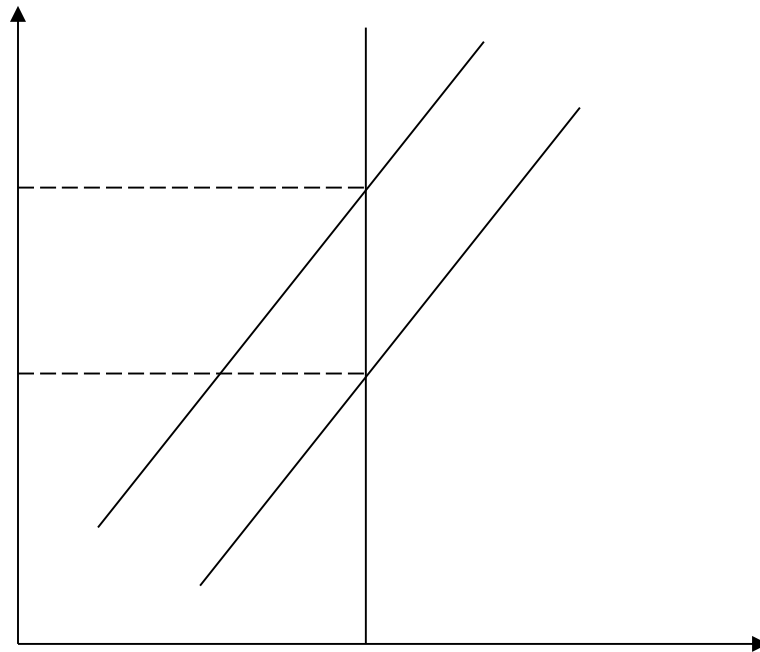
The whole tax is paid by the producer/seller



The price does not increase at all. Therefore the consumer does not bear any part of the tax. The whole tax is paid by the producer.

5) Where the demand for a commodity is perfectly inelastic

The whole tax is paid by the consumer.



The tax shifts the supply curve to the left from S_1 to S_2 . The consumer's portion of the tax is shown by the increase in price from P_1 to P_2 and this is equal to the tax ab , meaning that the consumer bears the whole tax burden.

Questions:

- 1) Apply the concept of price elasticity of demand to:
 - (a) Tax incidence
 - (b) Subsidies
- 2) Determine the incidence of tax when demand for a commodity is elastic but supply is inelastic
- 3) Determine the incidence of tax when the demand for a commodity is inelastic but supply is elastic

Effects of price elasticity of demand on subsidies (Negative tax)

A Subsidy is a grant / financial assistance by the government to the producer/consumer of a given commodity aimed at encouraging the production or consumption of that commodity.

The effect of a subsidy is the opposite of that of a tax, and hence a subsidy is sometimes called a negative tax.

Effects of a subsidy include:

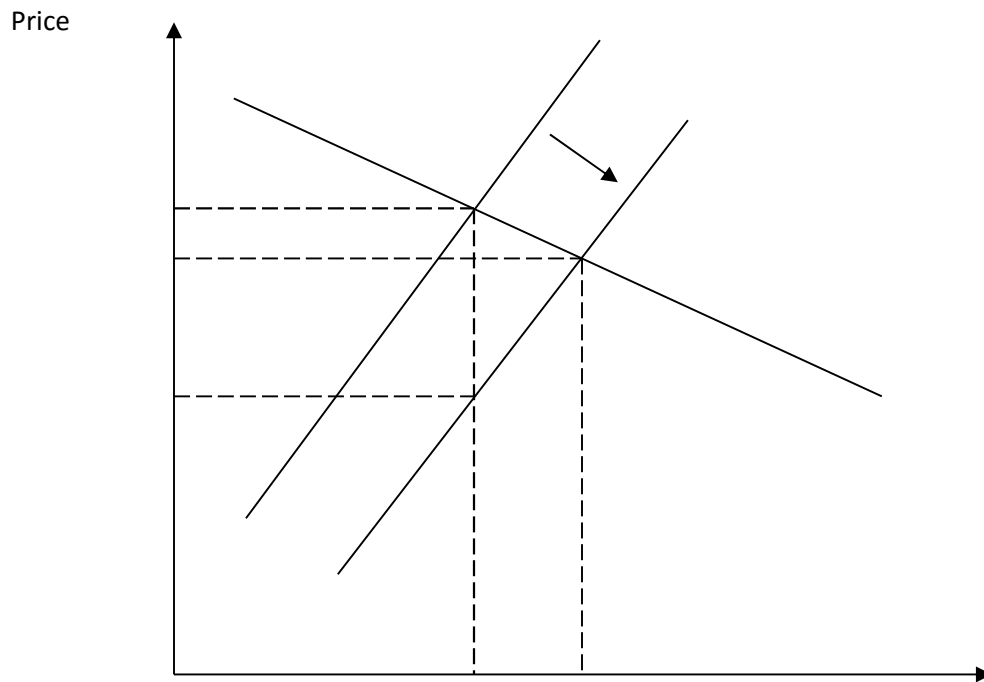
- Reduction in the cost of production
- Increase the level of output.
- Increase consumption of the commodity
- Reduction in the price of the commodity.

Like the tax, a subsidy extended to a producer can be shared between the producer and the consumer depending on the price elasticity of demand (and price elasticity of supply)

After extending a subsidy, a producer supplies more and hence the supply curve shifts to the right

1) *Where the demand for the commodity is elastic.*

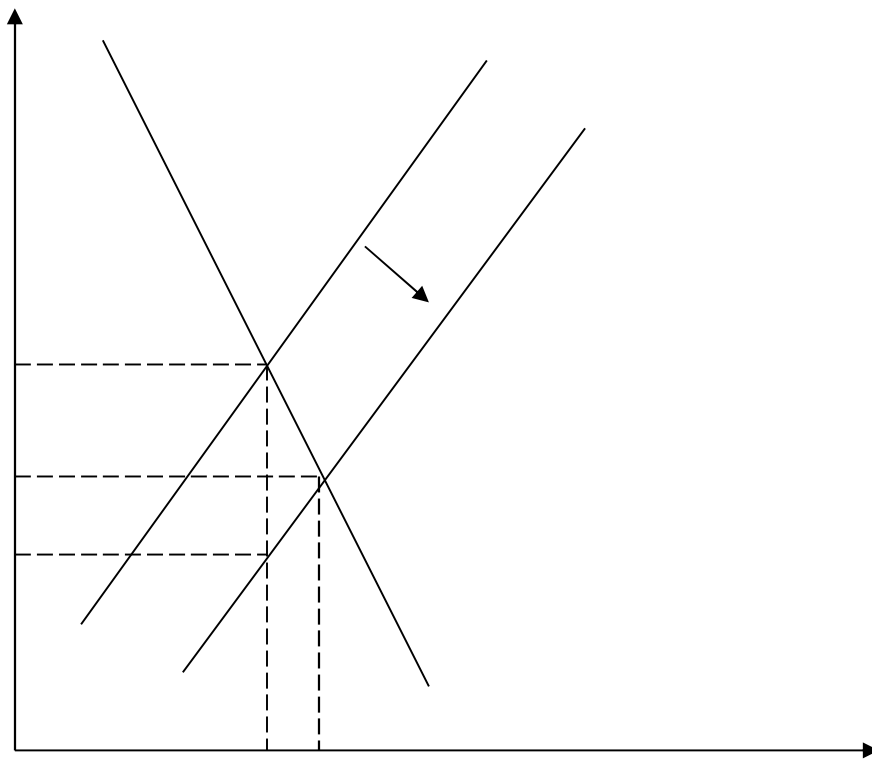
The bigger portion of the subsidy goes to the producer and the smaller portion goes to the consumer.



Area peCGE represents the total subsidy. The bigger portion DCGF goes to the producer while the smaller portion PeDFE goes to the consumer.

2) *Where the demand for the commodity is inelastic*

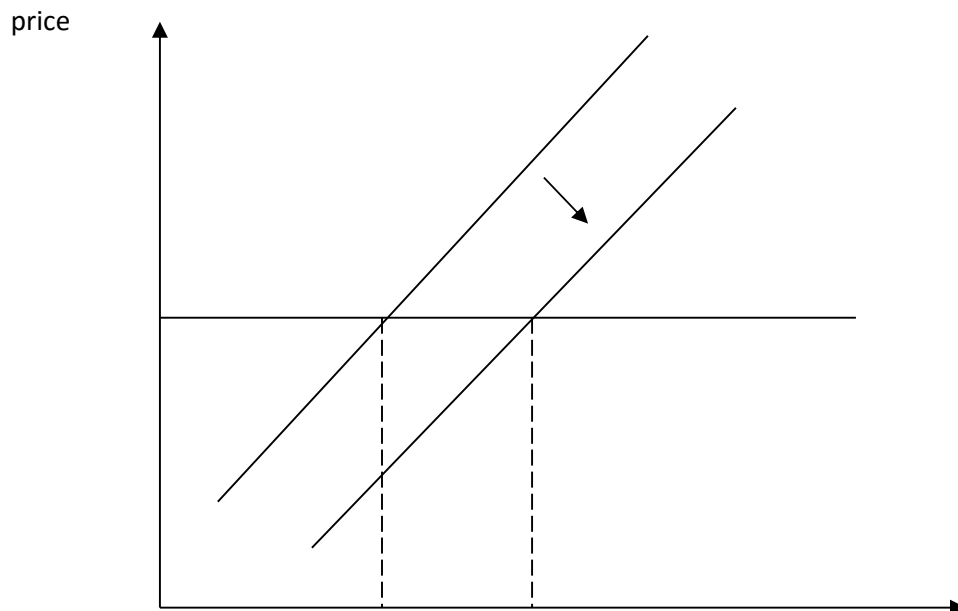
The bigger portion of the subsidy goes to the consumer while a smaller portion goes to the producer.



The consumer benefits more from the subsidy by a reduction in price from P_1 to P_2 . The producer gets a smaller benefit indicated by P_2P_3 .

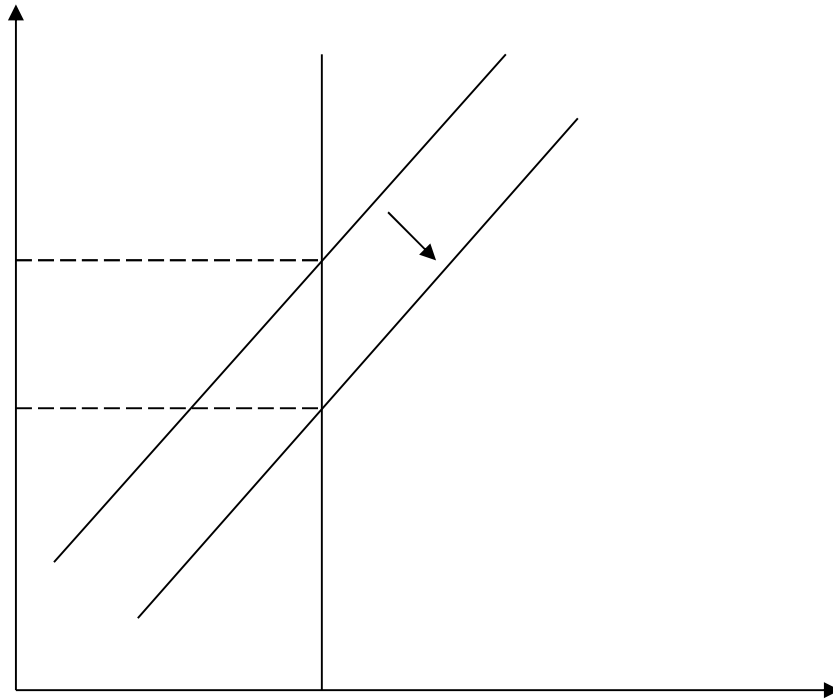
3) Where demand for a commodity is perfectly elastic

The whole subsidy goes to the producer i.e. the producer benefits wholly from the subsidy.



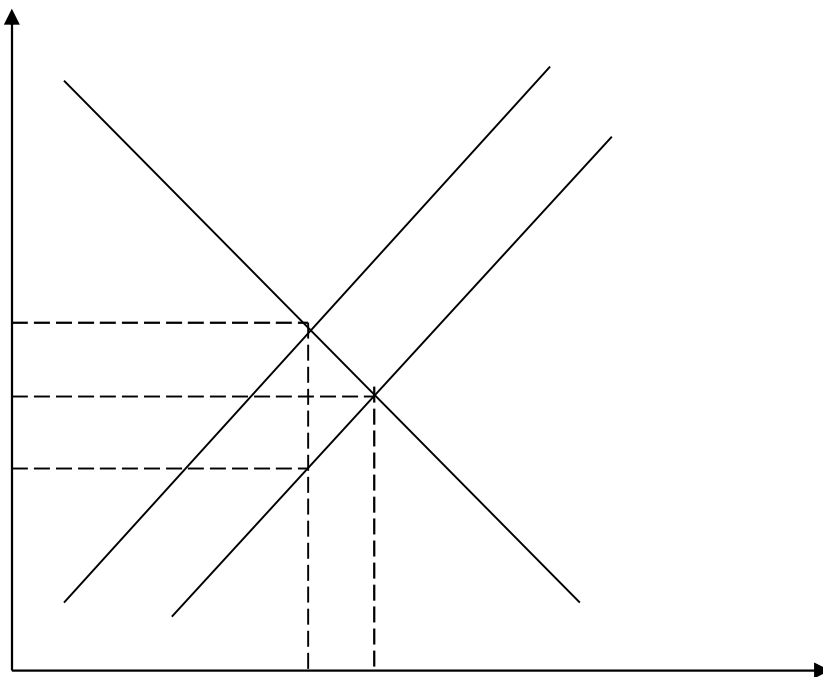
4) Where demand for a commodity is perfectly inelastic.

The whole subsidy goes to the consumer i.e. the consumer benefits wholly from the subsidy.



5) Where demand for a commodity is unit elastic

The subsidy is shared equally between the producer and the consumer.



The subsidy shifts the supply curve to the right from s_1 to s_2 . Price reduces from P_1 to P_2 and quantity demanded increases from Q_1 to Q_2 .

The size of the subsidy is the vertical distance between the original and the new supply curves. Consumers benefit from this subsidy by a reduction in price from P_1 to P_2 . Producers benefit from the subsidy by a reduction in their supply price equal to P_2P_3 .

Qn. Apply the concept of price elasticity of demand to subsidies

The tax structure in Uganda/ structure of taxation in Uganda

A tax structure refers to the composition of the tax system regarding the nature/type of taxes, mode of payment, proportion of income paid as tax and other characteristics.

The characteristics of Uganda's tax structure include:

1. Uganda's tax system has both direct and indirect taxes, but Uganda relies more on indirect tax than direct tax. The indirect taxes contribute a bigger percentage of Uganda's revenue than direct taxes. *[the tax system of the country is highly regressive since the indirect taxes that are regressive dominate]*
2. The major types of direct taxes in Uganda include: income tax (PAYE), general tax, corporation tax, capital gains tax, local service tax etc
3. The major indirect taxes in Uganda include: VAT (Value Added Tax), import duty, excise duty, etc
4. The rate of these taxes differs from commodity to commodity, from different income levels, and from time to time.
5. There are also some few non-tax sources of revenue such as licenses (trade license, drivers' licenses etc), fines and penalties etc
6. The assessment and collection of most taxes is the responsibility of Uganda Revenue Authority (URA). The body has two major departments: the customs and excise department and the internal revenue department.
7. There is still a narrow tax base and limited variety of taxes, hence low tax collections and tax deepening—high tax rates on few items in attempt to raise revenue.
8. A weak tax collection machinery such as personnel, facilities and lack of a comprehensive and integrated tax payers' data base, high corruption etc
9. Taxes on foreign trade such as import duties are significant in raising revenue for the country.

Value added tax

Refers to tax imposed /levied on value added to a commodity at every stage of production. *Value added is the difference between the gross value (value of total output) and the value of inputs.*

Terms under VAT:

- (a) **Zero-rated goods.** These are goods that bear no VAT but the supplier may claim back any VAT paid on inputs. Examples include: food, drugs, water, medicines, and international transportation of goods or passengers, export of goods or services.

- (b) **Exempt goods.** These are goods which are not subject to VAT but one cannot claim back any VAT already paid on inputs used. Examples: education services, financial services, paraffin, unprocessed foodstuffs.

Advantages of VAT

- VAT is economical/ easy to administer. The costs of collection are low since it is collected by the business people and then remitted to URA.
- It is comprehensive—covers a wide range of consumer expenditure (transactions and goods) and therefore results into higher revenue for the government.
- VAT leads to improvement in keeping of records by the business people. This is because its requirement for the business people that are charged VAT to properly organize their books of accounts.
- Convenient to the tax payer in that he pays when there is income.
- Easy determination of incidence of tax.
- It leads to an increase in revenue of the country (unlike former CTL and sales tax).
- Leads to a decrease in the level of corruption. This is because of the improvement in the keeping of records.
- VAT is difficult to evade or avoid as compared to other taxes. This is because it is distributed at various stages of production.

Disadvantages of VAT

- Leads to an increase in income inequality. This is because it is regressive in nature, and therefore the burden falls more on the low income earners.
- VAT results into higher prices of commodities.
- It reduces people's welfare as it results into an increase in prices of commodities, which leads to reduction in consumption.
- It is sometimes evaded where there is lack of proper keeping of records
- It is difficult to calculate and understand
- It is regressive in nature and falls heavily on to the poor.

Reasons why indirect taxes contribute a higher percentage of the country's revenue than direct taxes

(Use the advantages of indirect taxes and the disadvantages of direct taxes).

1. **Indirect taxes** have a wider coverage/ are comprehensive in nature yet direct taxes have a low coverage. Indirect taxes cover a wide range of activities in the country, hence raising more revenue.
2. Indirect taxes are difficult to avoid and evade unlike direct taxes.
3. It is cheap to administer indirect taxes/ easy to collect unlike direct taxes
4. **Indirect taxes** discourage consumption of certain harmful goods /undesirable commodities which is not the case with direct taxes.
5. Indirect taxes provide a more effective way of implementing the policy of protectionism unlike direct taxes.

6. Indirect taxes are more flexible than direct taxes.
7. Indirect taxes raise more revenue since there are many consumers than salaried workers to pay taxes.
8. Indirect taxes are more convenient to the tax payer because one pays only when he is ready to consume, unlike direct taxes which are usually paid as a lump sum and in advance.
9. Indirect taxes have a stabilization effect on the economy i.e. control inflation/ deflation, reducing importation to improve the BOP position.
10. *The low taxable capacity due to low income levels in developing countries. Also high degree of tax evasion, avoidance and exemptions –all of which limit scope of revenue from direct taxes and hence reliance on indirect taxes.
11. *Reluctance by developing countries' governments to tax existing companies highly in a bid to encourage foreign investment (tax holidays, tax concessions) also lowers revenue from direct taxes and thus reliance on indirect taxes.

Why do most people evade taxes?

1. Low income levels (general poverty). Many people are not able to pay taxes.
2. Unfair assessment of taxes without considering the 'ability to pay' principle.
3. Inadequate information regarding the importance of paying taxes
4. Dissatisfaction about the way tax revenue is used by the government / discontent about the provision of services by the government.
5. Laxity in the tax system i.e. weak tax system/administration such as involving corruption. There are many loopholes in the tax system.
6. Desire to retain all one's incomes.
7. Political sabotage because of dislike or unpopularity of the government in power.
8. Sabotage from other sections of the population such as opposition politicians.

***Reasons for the low taxable capacity in Uganda**

- Low levels of income
- Large subsistence sector
- High level of income inequality
- Political insecurity in some areas of the country.
- Dominance of the agricultural sector
- High level of unemployment
- Low levels of investment
- Poor tax administration
- Ignorance of the people about the importance of taxation.
- High cost of living/ high price level /high rates of inflation
- Poor infrastructure

Factors determining the amount/ level of revenue from taxation

1. Size of the tax base.
2. The taxable capacity
3. The degree of accountability/ level of corruption.
4. Level/ rate of tax avoidance
5. Level of tax evasion
6. The number/level of economic activities
7. Availability of data/ information
8. Level of monetization and/ commercialization of the economy.
9. The skills of tax administrators/ collectors
10. The cost of tax collection and administration.
11. Level of infrastructural development
12. The tax rates
13. The political climate
14. The level of tax incentives/ exemptions(to would be tax payers)
15. Size of the industrial sector

Causes of low tax revenue collection in developing countries

1. **The low taxable capacity.** Most people are get very low incomes and cannot pay the taxes imposed on them and remain with a comfortable life. Accordingly, many people are below the tax threshold, hence not taxed.
2. **The narrow tax base.** There are few economic activities, incomes, firms, industries on which taxes can be imposed. Accordingly low tax revenue is collected.
3. **High rates of tax evasion.** Many individuals and firms deliberately dodge payment of taxes such as failing to declare their incomes, smuggling goods across the borders, which results into loss of revenue. More so the rich, politicians, and those having connections to the leaders tend to dodge paying tax.
4. ***Increase in trade malpractices** such as smuggling, under declaring the value of imports and exports, thus leading to low tax revenue collected.
5. **High rates of tax avoidance.** There are a number of weaknesses in the tax system and tax laws which individuals take advantage of to pay less or no tax at all. For example some taxes are imposed particular activities and not on others.
6. **High rates of corruption and embezzlement.** Some of the tax official s use the revenue collected from taxation for their own private / personal benefit. Also some tax officials are bribed by the tax collectors to under declare the goods to be taxed. There is also incompetence of tax administration machinery.
7. **The weak tax administration.** This is in form of inadequate supervision and monitoring which leads to inefficiency in tax collection and thus low revenue.
8. **High costs of tax administration.** A big percentage of the revenue collected from taxation is spent on the tax officials during assessment and collection.

9. ***Tax concessions/exemptions by the government.*** Fear of the government to impose heavy taxes on foreign owned industries and local people due to fear of being unpopular. Tax holidays and tax relief exist especially on the foreign investors.
10. ***Political instabilities in some areas of the country.*** These prevent the tax collectors from accessing such areas to collect taxes. Instabilities (*rebel activities, uprisings, demonstrations etc*) also limit productive activities.
11. ***Poor infrastructure especially transport routes.*** This hinders movement of the tax collectors and tax assessors in some areas, leading to limited tax revenue.
12. ***Large subsistence sector.*** Some activities are intended for the production of goods for own consumption, thus the activities of the sector cannot easily be taxed, and this makes the tax base small.
13. ***Small industrial sector.*** There are not many big companies and viable income generating projects. This leads to low production and output on which taxes are imposed, thus leading to low revenue.
14. ***High levels of unemployment.*** Many people are not in productive /active employment i.e. many people do not have meaningful jobs. This limits income and hence limits tax.
15. ***Wide spread poverty in the country and income inequalities,*** with low per capita income. There are many people living below the poverty line and yet incomes are concentrated in the hands of a few people. This also limits the tax assessment and thus low tax collections.
16. ***Narrow definition of lawful activities.*** Many activities are taken as illegal and thus not taxed such as prostitution, coaching students, local brewing.
17. ***Ignorance of many Ugandans and discontent amongst people*** on how tax revenue is spent. Many people do not understand the value of paying tax and still many question how the tax revenue is spent. This makes many people reluctant to pay taxes.
18. ***Limited information about people's incomes and wealth.*** There is no comprehensive database on people's incomes for example because many people are in unstable employment/ keep changing jobs. This limits the effectiveness of the tax assessment.

Steps being taken to widen the tax base and taxable capacity/ measures for increasing revenue from taxation

1. ***Strengthening and implementing of tax laws.*** This also involves revising old laws to meet new challenges and current developments. This helps to discourage tax evasion and corruption in the tax system.
2. ***Anti-corruption laws being enforced.*** This involves auditing books of accounts, and working with the justice arm of government to fight the revenue corrupt officials.
3. ***Strengthening revenue collection bodies /agencies*** to deal with the administration and collection of taxes. There is also empowering of the anti-smuggling units.
4. ***Sensitization of the masses/Wide tax education*** is being done to raise tax awareness /importance of paying tax and the payment procedure among the population. This lowers tax evasion and non-compliance.
5. ***Diversification of taxes*** through introduction of new taxes such as property tax, land tax in order to widen the tax base.

6. **Encouraging investment in the economy/ diversification of the economy** in order to widen the tax base. This involves expanding industry, formal employment, tourism etc.
7. **Encouraging privatization and liberalization policy** to boost investments by the private sector in various activities and in turn widen the tax base.
8. **Massive industrialization programs** such as by setting up agro-based industries on which taxes can be imposed.
9. **Encouraging fair assessment of taxes.** That is, imposing taxes on people basing on their income brackets and wealth to avoid over taxation which results into tax evasion.
10. **Training and recruitment of qualified and competent personnel** into the tax authority/ departments, and also improving the remuneration of staff that works in assessment and collection of taxes. There is also on—job training to increase staff efficiency and effectiveness.
11. **Encourage more indirect taxes** which are difficult to evade.
12. **Ensuring political stability in many parts** of the country. This ensures that the different parts of the country are accessed for tax assessment and collection.
13. **Improvement in the country's infrastructure** such as road network to facilitate the movement of tax officials in the different areas of the country as they collect the taxes.
14. **Encouraging proper and effective use of the tax revenue.** For example by using the revenue to put up infrastructure to benefit the tax payers, and hence enable them to pay taxes promptly.

Problems faced by tax authorities in Uganda (developing countries)

1. **High level of tax evasion.** Many people decide to refuse/dodge paying the taxes imposed on them by the government and it is hard to trace the tax defaulters. Many people under declare their incomes, smuggle goods in and out of the country.
2. **High level of tax avoidance.** Many people exploit the loopholes/weaknesses in the tax system to pay less or no tax at all.
3. **Narrow tax base.** There are few productive activities in the country which can be taxed and this limits the tax revenue. The high rate of unemployment further narrows the tax base.
4. **Shortage of skilled manpower** in some departments. There is limited competent labour to assess and collect taxes. Often times planned revenue greatly exceeds actual revenue. More so there is lack of a comprehensive tax payers' database—leading to over taxation, under taxation and subjective assessment.
5. **Limited facilities/logistics to use** such as transport facilities (vehicles) to move to the remote areas, security facilities, computer to analyze and store. This leads to inefficiency in the tax system.
6. **Low taxable capacity.** Most people are unemployed, under employed, earn low incomes or are just dependants. Still many enterprises earn less profit leading to low tax rates.
7. **Poor infrastructure.** For example poor roads which hinders the movement of the tax assessors and tax collectors in certain areas to collect the revenue for the government treasury.
8. **High rate of corruption and embezzlement** by some of the tax officials. These misuse the collected funds to their private benefit. Still some officials receive bribes, under assess or at times over assess—leading to evasion. This leads to low tax revenue.

9. **Political instability in some parts of the country.** This discourages the movement of the tax assessors and tax collectors in such areas.
10. **Political interference.** There are conflicting government interests such as electioneering where some taxes are waved-off or reduced, yet the government may fear to levy high taxes to protect its popularity. [*Sometimes the government officials interfere in tax assessment and collection which makes the tax officials fail to make independent decisions*].
11. **Conflicting government objectives.** For example putting up tax concessions towards the investors (which leads to loss of revenue), and yet government wants the revenue bodies to collect more tax revenue. This leads to over taxation of other activities to recover the revenue.
12. **Resistance from public against tax payment** especially those taxes which are perceived as unjustified. Often times there are hostilities against the tax authorities in case of over taxation.
13. **Difficulty in identifying taxable sources** such as income for taxable purposes. There are many ways of earning income such as small earnings for peasants, prostitution –not taxable by law.
14. **Frequent changes in employment, contacts and residence / large informal sector** which is not properly organized. This makes it possible to follow up/ to trap tax payers and hard to determine the taxable capacity.
15. **High rates of inflation** leading to loss of value of money from taxes assessed before. Hence, the expected benefits from taxation cannot be realized.

PUBLIC DEBT`

Refers to a debt incurred (*the amount of money borrowed*) by the central government, local governments and public corporations as a result of borrowing from within the country or from external sources.

Some concepts

1. Public debt and National debt

National debt refers to a debt incurred by the central government from internal and external sources excluding debts incurred by local authorities and public corporations.

While

Public debt refers to a debt incurred from internal and external sources by the central government, local authorities and public corporations.

2. **Insolvency.** This is a situation where a country is incapable of servicing its debt in the long run.
3. **Debt contraction.** Refers to the process of obtaining a debt/ a loan.
4. **Debt servicing.** Refers to the payment of interest on a loan.
5. **Debt redemption.** Refers to the payment of the public debt involving both the principal and interest.
6. ***Total debt stock.** This includes disbursed outstanding debts plus interest arrears.
7. **Soft loans (concessional loans).** These are loans where the interest rate is low, the repayment period is long and the terms of repayment are negotiable. Such loans are usually given by multi-lateral agencies such as IMF and World Bank and they are usually intended for poor countries.

8. **Hard loans.** These are loans with high interest rates, the repayment period is short and the terms of repayment are not negotiable. Such loans are usually given by countries and profit-making international companies.

CLASSIFICATION OF PUBLIC DEBTS

A. According to source of borrowing

- 1) **Internal debt.** Refers to a debt incurred by the state /government from the people and institutions within the country. This borrowing is usually done through the sale of treasury bills and bonds, compulsory schemes (such as NSSF), sale of other government stocks.
- 2) **External debt.** Refers to a debt incurred by the government by borrowing from other countries, foreign individuals, institutions or multi-lateral agencies. These include IMF, IBRD (World Bank), foreign private foundations, and multi-national corporations. External debts are usually for long-term borrowing usually for development expenditure.

B. According to how the public debt is used

1) **Reproductive debt (productive debt).** It is a debt incurred and spent on directly productive activities that can generate revenue, which can be used to repay the principal and interest (*the borrowed money*). The debt is spent in projects like such as construction of dams, industries etc. *[In other words, a reproductive debt refers to a debt covered by real assets and thus pays for itself i.e. it is self-liquidating].*

2) **Dead weight debt (unproductive debt).** It is a public debt incurred and spent on activities which are not directly productive and thus cannot generate revenue to repay the borrowed money.

[Or Refers to a debt not covered by any real assets and hence cannot pay for itself such as financing wars, national celebrations, elections etc. that is, dead weight debt is not self-liquidating]

C. According to repayment method/ period

1) **Funded debt.** This is a long-term debt for which the redemption period (*the time of paying back the borrowed money*) is not specified but annual interest is paid on it.

[The borrower keeps on paying annual interest but the specific date to pay the principal is not known].

2) **Unfunded debt.** Refers to a debt for which the time of paying back the borrowed money is well known and specified by the lender. **OR** This is a type of debt for which the redemption period/ repayment date is specified or fixed.

3) **Floating debt.** This is a form of unfunded debt with a very short repayment period.

For example, it is paid back within 3- 6months and it is usually obtained from the sale of treasury bills.

Why government incur public debts

('Advantages of public borrowing')

1. ***To supplement the tax revenue so as to meet the desired expenditure level*** such as financing the recurrent expenditure of the government—payment of salaries and wages of civil servants etc
2. ***To cover the foreign exchange gap resulting from balance of payment problems/ to finance BOP deficits***. The money borrowed from other countries in form foreign currency like dollars, pounds, francs etc is a source the scarce foreign exchange.
3. ***To reduce the tax burden on the citizens of the country***. Instead of imposing high taxes on the citizens, the government uses the alternative of borrowing to raise the required revenue. The people remain with more disposable income to leave a descent life.
4. ***To minimize political resistance to taxes and not to make government unpopular***. Public borrowing does not meet strong resentment from the masses since it does not immediately/ directly impact on them/ their incomes.
5. ***To reduce/control inflationary tendencies in the economy***. Internal borrowing through the sale of securities reduces the money supply and thus reducing aggregate demand –hence controlling inflation.
6. ***To fill the savings-investment gap***, by borrowing and encouraging capital inflow. Limited domestic savings to finance planned projects and production necessitates government borrowing to bridge the gap.
7. ***To repay government debts incurred in the past plus interest***. Public borrowing enables debt servicing and repayment of the principal to be possible. Thus, the developing countries are not reducing debts but switching from one lender to another.
8. ****It is a tool of fiscal policy to regulate or stabilize economic activities*** to a desirable situation such as to fight inflation. This is by reducing taxation, which would raise the cost of production.
9. ***To raise greater amount of revenue in a short time, unlike taxation***. Therefore, the government borrows to minimize discrepancies in the flow of government receipts/revenue from taxation.
10. ***To cover unforeseen budgetary deficits and emergencies facing a country*** from time to time such as natural calamities, wars, disease outbreak etc not budgeted for. Public borrowing enables the country to facilitate the affected areas with medicine, food, shelter etc
11. ***To increase the level of employment in the country***. Through public borrowing, the government increases its expenditure on employment generating activities/ investments.

Causes of increasing public debt in developing countries

1. Rapid population growth rates in developing countries. This causes heavy dependence ratio leading to increased consumer demand that must be met by a rise in government expenditure, causing increasing public debt.
2. Rampant political instabilities in some parts of developing countries. There is therefore need to finance war causing the government to incur high public debts.
3. Frequent budgetary deficits in developing countries, hence they on borrowing year after year.

4. Widespread campaign to construct public utilities such as roads, dams, water facilities, railways etc. (Ambitious infrastructural projects impose high costs to LDCs)
5. Expanding administrative units in developing countries and thus increased public borrowing.
6. Heavy borrowing not accompanied by productive investment especially in the 1970s and 1980s. The lenders were also not making careful examination about the fiscal policies and public enterprises.
7. Capital flights from developing countries/ private capital outflows. This results in transferring a country's resources to other countries, which reduces capital formation, investment and tax base. This in turn increases borrowing and hence foreign debt burden.
8. Policy mistakes by governments of developing countries. Loans are used for luxurious instead of productive investment, hence not self liquidating. Also some loans wasted in state-owned inefficient enterprises. Excessive money supply raises price levels and makes repayment of loans difficult.
9. The oil shock and global recession. The rise in oil prices raised the import bill/ expenditure of the developing countries and this forced them to borrow heavily to finance the increasing import expenditure.
10. The high interest rates yet the productive capacity of debtor countries (LDCs) is low. This increases debt servicing and hence the debt crisis.
11. Corruption and mismanagement in LDCs, which prevents effective use of foreign loans. Loans are also wasted in complex prestigious capital intensive projects or arms programs; yet there are incompetent financial management personnel.

Demerits of public debt

1. ***Creates external dependence of the borrower on the lender.*** Due to external borrowing, the country greatly relies on the decisions/conditions made the lending country or agencies. This leads to neo-colonialism.
2. ***Encourages laziness among the citizens and wastage of resources.*** There is wastage of resources and extravagance since many people think that borrowed funds are free.
3. ***Excessive external borrowing worsens the balance of payment problems of a country,*** especially during debt servicing. Debt repayment drains the scarce foreign exchange reserves of the country/ leads to high foreign exchange expenditure abroad.
4. ***Debt servicing limits the rate of capital accumulation and investment*** in the country. This is due to high capital flight to service and repay acquired debts. Most debts are given at ***high interest rates.***
5. ***Public borrowing shifts the burden of repayment to the future generations*** who may not have benefited from the public debt. The future generations are forced to pay high taxes in order to repay the debts. [*The future generation has a low capital base and BOP problems, due to loans incurred even irresponsibly.*]
6. It ***increases income inequality in the economy.*** For example by using a poor tax system to get money to repay the public debt—the poor are made to pay interest on loans and principal incurred by government to the rich (creditors, entrepreneurs). [*Still some times borrowed money is directed towards particular sectors of the economy.*]
7. ***Public borrowing from external sources is inflationary*** in the economy. It increases the amount of money in circulation, which results into increase purchasing power and thus inflationary tendencies.

8. ***Worsens people's standards of living***, as it reduces on private consumption and aggregate demand especially due to high taxes. Poverty and mass suffering increase.
9. ***Leads to loss of national sovereignty (political autonomy)*** to MDCs, IBRD, and IMF. Insolvency makes the debtor countries to be subjected to international financial control by the creditors. This deprives a self-sustaining, independent and progressive economy. *[some debts have a number of strings attached which may be political, economic, religious etc which the borrower country has to satisfy and this undermines national sovereignty]*
10. **Some of the borrowed money is tied to particular projects**, that may not be the priority of the country's plans and yet the money has to be paid back.
11. ***Unpredictable source of revenue***/results into the failure of some projects or some come to a standstill in case the borrowed money does not come in the promised time or the required amount. *[Public borrowing leads to economic instability since it makes planning difficult. This is due to uncertainty of debts and the strings attached].*
12. ***Public borrowing makes the government unpopular in the long run***. Sometimes it leads to riots, revolutionary uprisings, coups etc as people are questioning the worth of the borrowed funds.
13. ***Leads to underutilization of the country's resources**. The country tends to depend more on foreign resources instead of efficiently utilizing the locally available resources.

Burden of public debt

This is the real cost of borrowing on the present and future generations. Or It is the obligation on the part of the nationals of the country to repay the borrowed money plus interest.

The burden of the public debt is expressed as a proportion or percentage of the following:

1) Debt as a percentage of Gross National Product (GNP)

$$\frac{\text{Public debt} \times 100}{\text{GNP}}$$

This represents the percentage of national income committed to debt repayment.

2) Debt as a percentage of total population

$$\frac{\text{Public debt}}{\text{Total population}} \times 100$$

This shows the percentage of public debt per person i.e. debt burden per capita.

3) Debt as a percentage of labour employed

$$\frac{\text{Public debt}}{\text{Total labour employed}} \times 100$$

This shows the proportion of debt per employed labour (working population).

4) Debt as a percentage of foreign exchange earnings

$$\frac{\text{Public debt}}{\text{Foreign exchange earnings}} \times 100$$

This measures the percentage of exports required to repay the public debt.

5) *Debt as a percentage of imports*

$$\frac{\text{Public debt}}{\text{Imports}} \times 100$$

This is a measure of the percentage of a country's imports forgone when repaying public debt.

6) *Debt as a percentage of government revenue*

$$\frac{\text{Public debt}}{\text{Government revenue}} \times 100$$

The percentage of government revenue required to meet the public debt repayments.

7) **Debt as a percentage of interest on public debt (interest payable)*

$$\frac{\text{Public debt}}{\text{Interest rate}} \times 100$$

The burden is seen on the interest to be paid. If the interest rate is high, the burden will be heavy.

8) *Debt burden on the tax payer*

$$\frac{\text{Public debt}}{\text{Number of taxpayers}} \times 100$$

- 9) *The debt can also be expressed in the repayment period* i.e. long-term, medium term, and short term loans. If it is the short period and the debt is unproductive, then the burden will be high, but if the debt is productive and the repayment period is long enough the burden will be light.

Public debt management

Refers to the ways and means by which the government administers the public debt, that is, how it is obtained, controlled, serviced and later repaid. **OR** refers to the process of acquiring , utilizing, servicing and repayment of the debts by the central government, local authorities or public corporations.

[Public debt management involves the actions of the monetary authority to regulate the size and structure of the outstanding debt, to reduce the debt burden].

Objectives of public debt management

- 1) To maintain price stability in the economy
- 2) To reduce income inequality / to influence income distribution in the economy
- 3) To ensure proper utilization of the borrowed funds (such as by controlling corruption)
- 4) To influence the interest rate
- 5) To mobilize financial resources for a country's development
- 6) To influence the level of liquidity within the economy
- 7) To reduce the debt burden/ to minimize the cost of the public debt.

Debt Redemption

Refers to the payment of the public debt involving both the principal and interest.

Methods of debt retirement/ debt redemption (methods of reducing the size of the public debt/debt burden)

Internal debts:

- 1) **Creation of a sinking fund.** This is a fund set aside by the government every year from its revenue for future debt redemption. Government sets aside a certain amount of money each year out of its budget and it is out of this fund that loans are repaid /cleared.
- 2) **Use of surplus budget.** This involves the government planning to spend less than expected revenue in given year. This surplus revenue is then used to clear internal debt.
- 3) **Debt conversion.** This involves the government contracting new loans from a lower interest rate source to pay back the old public debt (old hard loans).
- 4) **Privatization of public enterprises/utilities.** The government can sell some of the parastatals and the money received is used to clear public debt.
- 5) **Use of profits generated from government/public enterprises** to clear / repay the public debt.
- 6) **Raising revenue by levying taxes.** For example Capital levy—which is a special tax usually on the rich class by the government for certain purpose. The revenue got can be used to clear public debt.

External debt

The external debt can be cleared in the following ways:

- 1) **Disinvestment.** This involves the sale of government investments and properties (assets) abroad and the money raised is then be used to clear the public debt.
- 2) **Debt Rescheduling.** This involves the government postponing the repayment date through negotiation with the lender/creditor. This is done by PARIS CLUB (the rich countries of western industrialized nations). Many countries have benefited such as Uganda.
- 3) **Negotiation for debt cancellation/debt relief.** This involves an appeal and negotiations with creditors who can then sympathize and wave off the debts. But the debtor country must satisfy certain conditions to have its debts cancelled.
Countries with democracy and structural economic reforms have benefited.
- 4) **Use of donations and grants.** Assistance given by other countries and multi-lateral agencies can be used to clear the public debt if it is unconditional (not tied).
- 5) **Use of the country's foreign exchange reserves** to settle foreign debts such as SDRs, Gold etc
- 6) **Negotiation for debt reduction.** The outstanding debts of LDCs are reduced together with the interest payable. Sometimes the principal is reduced or the interest or the interest cancelled.
- 7) **Unrequited exports.** This involves exporting goods to the lender country without expecting any payment and using the value of the goods to offset the debt.
- 8) **Debt Repudiation.** This involves government complete refusal to pay its public debt. The government refuses to honor its debt obligations. However the country may be diplomatically isolated and may not easily borrow in future and it even affects foreign direct investment in the country.

- 9) Export promotion strategy. This involves deliberate effort by the government to expand the volume of exports so as to earn more foreign exchange and use the money to clear public debt.
- 10) Budget control—but most LDCs are reluctant towards strict budget control for political and other factors.

Difficulties in internal borrowing in developing countries (factors that limit internal borrowing)

1. Underdeveloped capital and money markets in developing countries , hence selling of securities by government becomes difficult.
2. High rates of inflation.
3. Most people have high liquidity preference i.e. prefer to keep their assets in cash form.
4. People in LDCs also prefer to invest in real estates which give social prestige instead of investment in government securities.
5. The low rates of interest offered by the government, discourage people from buying security (because it is very low).
6. Ignorance of the majority of public about public borrowing. Many people do not know much about the selling and buying of securities.
7. Failure to maintain good investment climate, hence the public is not certain of the future.
8. Political instabilities common in most developing countries also discourage the public from buying securities.
9. Fear of non-payment by the government
10. Low levels of income.

****Reasons why Uganda continues to rely on loans***

- *Low tax revenue*
- *Low domestic savings*
- *The need to finance long term development projects*
- *Low export earnings*
- *Rising need for imports*
- *Persistent budgetary deficits of the government*

DEFICIT FINANCING VERSUS TAXATION FINANCING

Deficit financing

Refers to a situation where the government depends on borrowing to finance its recurrent and development expenditure that may not be covered by tax revenue.

Note: Deficit expenditure refers to the government expenditure, which is in excess of the government revenue collected.

Alternatively, refers to the amount by which planned government expenditure exceeds realized tax revenue. Such expenditure is normally financed by borrowed funds (and printing more money by the central bank).

The major objective of deficit financing is to: stimulate economic activities by increasing the purchasing power / aggregate demand in the country, to avoid negative effects of taxation, to raise the disposable income of the people and this increasing consumption.

Advantages of deficit financing

1. ***Deficit financing raises greater amount of revenue in a short time to meet government expenditure unlike taxation.*** Therefore, the government borrows to minimize discrepancies in the flow of government receipts/revenue from taxation. Deficit financing raises money in a lump sum/ large sums than taxation.
2. ***Deficit financing reduces the tax burden on the citizens of the country.*** Instead of imposing high taxes on the citizens, the government uses the alternative of borrowing to raise the required revenue. The people remain with more disposable income to leave a decent life.
3. ***Minimizes political resistance to taxes and wins political support for the government.*** Public borrowing does not meet strong resentment from the masses since it does not immediately/ directly impact on them/ their incomes.
4. ***Deficit financing involves voluntary transfer*** i.e. creditors give willingly unlike taxation financing. It does not involve coercion of the lenders unlike taxation where the tax payers are forced to pay.
5. ***Deficit financing also improves a country's relations with other countries and international bodies*** such as ADB, IMF, IBRD etc. This in turn increases capital inflow and expands market for the export commodities of the country.
6. ***Deficit financing enables government to undertake big investment activities /projects*** which otherwise are difficult basing on tax revenue (development expenditure).
7. ***Deficit financing increases the level of employment in the country.*** In the short run, it increases on aggregate demand, production and creates many employment opportunities. (*Through public borrowing, the government increases its expenditure on employment generating activities/ investments*).
8. ***Government can also repay the borrowed sum plus the interest by borrowing from another country*** without actually imposing the burden onto people. (Public borrowing enables debt servicing and repayment of the principal to be possible).
9. ***It helps to covers unforeseen budgetary deficits and emergencies facing a country*** from time to time such as natural calamities, wars, disease outbreak etc not budgeted for. Public borrowing enables the country to facilitate the affected areas with medicine, food, shelter etc. (since adequate revenue cannot be acquired suddenly, deficit financing is the alternative resort).
10. ***Deficit financing enables a country to mobilize resources from internal and external sources*** unlike taxation, which is limited to a country/ internal sources.
11. ***It is a tool of fiscal policy to regulate or stabilize economic activities*** to a desirable situation such as to fight inflation. This is by reducing taxation, which would raise the cost of production.

Disadvantages of deficit financing

1. Deficit financing may be inflationary especially if a country is on full employment level.
2. Deficit financing has many strings attached and this can make a country to be politically and economically dependent on the creditors.
3. It fosters/enhances laziness and hence destroys spirit of self-reliance. The dependence syndrome causes a 'vicious of foreign aid'.
4. Payment of borrowed funds is a burden to the future generations. It may require increment in taxation, which reduces disposable income.
5. Borrowing also makes planning difficult in case it fails to come in time. Foreign sources of funding are not guaranteed.
6. Deficit financing enhances wastage and undertaking of over-ambitious projects.
7. Debt management is expensive, since it involves high administrative and even management costs.
8. Deficit financing negatively affects the balance of payment position. This is because it involves capital outflow in form of debt servicing and debt repayment.
9. It does not foster civic responsibility unlike taxation, but it creates the tendency to misuse /misappropriate the borrowed funds, since it is to be paid in future.

Taxation financing

Refers to a situation where the government depends on revenue from taxation to finance its recurrent and development expenditures.

Advantages of taxation financing

1. Promotes self-reliance and reduce dependence on foreign financial resources.
2. Promotes civic responsibility and checks against misuse by the tax payers.
3. Taxation improves on income distribution where a progressive taxation policy is applied.
4. (refer to taxation)

Demerits of taxation financing

1. It may cause resentment as the burden of taxation hits people.
2. Developing countries have low taxable capacity and low tax base, and thus financing cannot raise adequate revenue.
3. High taxation discourages enterprises and also limits foreign investment.
4. The tax burden rests on a few tax payers such as businessmen, workers etc and thus it is evenly distributed.
5. (Refer to taxation)

GOVERNMENT EXPENDITURE

Refers to the amount of money spent by government on behalf of its nationals.

Public expenditure refers to the amount of money which the government spends on the provision of public services such as education ,health, maintaining law and order.

NB: Public expenditure may also involve transfer payments (such as on pensions, subsidies, bursaries) emergencies (famine, epidemics)

Government expenditure is sub-divided:

(a) Recurrent expenditure. Refers to the government expenditure/spending on day to day activities/running of the state aimed at maintaining the existing capacities (projects and establishments), so that the current production of goods and services goes on. For example government expenditure on paying salaries and wages of civil servants, maintaining law and order/ security, rent etc

Recurrent expenditure is usually financed by money from taxation. It is sometimes called ***operating or consumption government expenditure***.

(b) Development expenditure (capital expenditure). Refers to government expenditure on long-term developmental investments/ projects and facilities intended for future production of goods and services.

OR Refers to government expenditure on the establishment of projects for purposes of both expanding existing capacities and creating new ones to generate more goods and services. For example, power generation, industry, road construction.

The structure of government expenditure in Uganda

This is concerned with the different items on which the government spends money. The major items of expenditure in Uganda include:

- 1) Payment of wages and salaries of civil servants.
- 2) Expenditure on security and defense such as on police , army etc
- 3) Expenditure on health such as public health centres, immunization, reproductive health etc
- 4) Expenditure on education such as on UPE, USE, tertiary education etc
- 5) Expenditure on poverty alleviation programs such as prosperity for all.
- 6) Expenditure on development and rehabilitation of infrastructure such as power and energy projects, road net work etc
- 7) Expenditure on debt servicing and debt repayment of the borrowed money with interest
- 8) Expenditure on agricultural development such as agricultural research, modernization etc

Reasons for the increase in government expenditure in Uganda

1. High/Rapid population growth rate, which leads to increasing expenditure on providing social services like medical care, education
2. Endless political insecurity in some parts of the country, which result into increasing military expenditure.

3. Rising levels of corruption and embezzlement by public officials, thus increasing/rising costs of fighting corruption such as rising expenditure on commissions of inquiry
4. Huge expenditure on foreign missions. There is rising expenditure on international commitments/engagements.
5. Persistent debt servicing/ increasing expenditure on the settlement of the public debt.
6. Increasing administrative costs, due to increasing size of public service, new districts, frequent/ endless by-elections, large cabinet etc. this results into increasing public expenditure.
7. Increased campaigns for wide spread provision of public utilities such as water, electricity
8. Rising costs of infrastructural development.
9. Rising emergency fund due to frequent natural hazards
10. Continuous over ambitious planning.
11. High rate of inflation, leading to rising costs of project implementation.

***Canons of public expenditure**

These are guidelines / basic rules governing government expenditure in order to achieve stated objectives.

1. Elasticity /flexibility. It should not be rigid but should change with economic requirements.
2. Economy. Since resources are scarce, public expenditure should be carried out in such a way to avoid wastage of funds.
3. Neutrality. Public expenditure should neutralize all adverse effects on production and distribution.
4. Canon of sanction. Public expenditure should be made by authorization by proper body such as parliament. Funds should be used for what it has been sanctioned and this checks misappropriation of funds.
5. Surplus. Government should try to avoid deficit budget—to avoid running into debts and over spending.
6. Public benefit. Public expenditure should have maximum social benefit i.e. benefit to society. It should also have positive effects on production, income and wealth distribution.

***Effects of public expenditure**

1. Fights against economic instability i.e. it stabilizes incomes, prices, employment, etc
2. Increases aggregate demand thereby creating conditions favorable to increased production and economic growth.
3. Creates and maintains social overheads such as hospitals, schools, etc which in turn improves social welfare and quality of life.
4. Public expenditure on social and economic infrastructure increases productive capacity of the economy and hence economic growth.
5. Provides subsidies to commercially non-profitable ventures but which are essential such as sewage disposal, investment in backward regions.
6. Promotes equitable income distribution provision of subsidies and welfare facilities such as health, free education, water supply, old age pensions, unemployment benefits etc

THE NATIONAL BUDGET

A national budget is a document showing estimated/ planned government expenditure and estimated government revenue in a given financial year.

It is usually presented by the Minister of finance to parliament at the end of a given financial year and it is made for the next financial year.

Economic objectives of the national budget

1. To check on the balance of payment deficit and this can be done by imposing high import duties.
2. To regulate money supply in the economy through appropriate monetary policy.
3. To check inflationary or deflationary tendencies in the economy/ to attain price stability by controlling inflation to desired levels.
4. To reduce income inequality.
5. To attain balanced regional development.
6. To achieve greater employment opportunities and resource utilization.
7. To increase people's welfare and reduce poverty, illiteracy, and disease.
8. To protect a country's local infant industries from foreign competition.
9. To increase the rate economic growth.

The national budget as an instrument of social and economic policy

***Note:** The budget reviews the performance of the previous year's budget. It shows the expenditure and revenue patterns of the ending financial year, and indicates the plans for the following financial year.*

1. **Mobilization of internal revenue for the government.** The budget indicates the internal sources of public revenue to finance expected expenditure such as by raising taxes, introduction of different forms of taxes grants, use of government securities etc. Also the necessary adjustments are also reflected.
2. **Mobilizing of external resources for the country/government.** The external lenders, donor countries and agencies always require looking at the country's budget as a precondition for extending assistance and hence the budget has to meet the standards of the donors.
3. **The budget stimulates/ accelerates the economic growth rate.** This is by promoting the level of savings and investment in the public, private and export sectors using favorable /appropriate policies such as infrastructural and industrial development.
4. **Reflects the development expenditure to increase the level of employment** such as public works, road construction, power generation, industrial development etc. Through the budget, the government also lowers taxes on investments and regulates the interest rates to create more jobs.
5. Reflects measures aimed at **minimizing inflation and attaining price stability in the economy.** For example by imposing high direct taxes which reduce the disposable income and thus reduced

aggregate demand. [A surplus budget controls inflation while a deficit budget controls deflation. Hence, a proper balance puts the economy at the desired price levels].

6. **Checks the balance of payment deficit of an economy.** This is achieved by raising taxes on imports to discourage importation of commodities, hence reducing foreign exchange expenditure abroad. Also tax relief to exporters, and proper public debt management checks on the BOP deficit.
7. **Reflects planned expenditure on social services** such as education, health facilities, defense/security, water supply etc. to improve the standards of living, the government raises its expenditure on the provision of such services.
8. **Alleviation/reducing of poverty and raising the standards of living** –through appropriate policies such as giving of soft loans to the public, reducing taxes to raise purchasing power etc. [The national budget also **reduces income inequality** by using progressive taxes reflected in the national budget. Through budgeting more revenue is raised by increasing taxes on the high income groups and then spending the revenue on the low income groups]
9. **Protects the country's domestic/infant industries from foreign competition.** This is done by subsidizing local industries and imposing high import duties to discourage imports that compete with the locally produced goods.
10. **Discourages the consumption of undesirable commodities in the country.** This is done by imposing high taxes on imports on such commodities as reflected in the national budget.
11. **Influences resource allocation in the economy.** For example by imposing lower taxes on certain activities that the government wants more resources to be allocated, and high taxation on non-priority sectors—reflected in the budget.
12. **Ensuring balanced regional development in the country.** This is by effective planning for resource allocation in the different areas, giving the under developed areas priority such as in the setting up of infrastructure.
13. **Regulation of government expenditure.** Through the national budget the government plans to reduce its spending on certain items such as by introducing cost sharing for certain items/ services such as education, medical services.
14. **Promotes economic independence of the country.** The budget does this through a number of policies such as encouraging import substitution industries, imposing high taxes on imports to discourage importation from other countries.

Types of budget

- A) Balanced budget
- B) Unbalanced budget

Balanced budget

Refers to a budget where estimated government revenue is equal to the estimated government expenditure for a given financial year. It is sometimes called **a neutral budget**.

Advantages of balanced budget

1. Encourages self-reliance i.e. reduces external dependence.

2. Discourages external borrowing.
3. Minimizes the balance of payment problems.
4. Does not encourage wastage of resources.
5. It is not usually inflationary.
6. Usually does not encourage undertaking of ambitious projects.

Disadvantages of balanced budget

1. Does not encourage the participation of foreign capital in the economy.
2. It cannot be used to fight inflation.
3. Economic activities may not be adequately stimulated especially in poor countries.
4. May lead to reduced rate of employment opportunities in the economy.
5. It leads to high rates of taxation and hence high burden on the populace.

Unbalanced budget

Refers to a budget where estimated/anticipated government expenditure is not equal to estimated government revenue.

This takes on two forms: surplus budget and deficit budget.

Surplus budget

Refers to a budget where the estimated government expenditure is less than estimated revenue.

Note: **A budget surplus/ budgetary surplus**—refers to the amount by which the expected government revenue is greater than/exceeds its planned government expenditure in a given financial year.

Arguments for surplus budget

1. Reduces/controls inflationary pressures. This is through imposing high direct taxes to raise more revenue but reducing expenditure so as to reduce disposable income, aggregate demand to control inflation.
2. Enables the government to accumulate reserves for future use (future investment and financing government projects). The budget surplus can be kept by the government for future.
3. Enables the government to clear / pay off its public debts.
4. The government is in position to advance loans and grants to other countries from the surplus.
5. Reduces a country's dependence on other countries in terms of budget support.

Arguments against surplus budget

1. May encourage heavy taxation of the citizens. This is because the government may tax people highly to raise more revenue. This in turn lowers consumption and industrial activity.
2. May put a country's economy in a depression/level of business activity may reduce and the economy may suffer from economic slump. This is because high taxes discourage private savings and investment.

3. Reduces on government spending on social services like education, health; this reduces economic growth and development.
4. Reduces aggregate demand in the economy, which discourages investment and employment. This is due to high taxes which reduce people's disposable income and the purchasing power.
5. Results into a deflationary situation i.e. persistent fall in the general price level in the economy.

Deficit budget

Refers to a budget where estimated/planned government expenditure is greater than the estimated government revenue.

Note: A Budget deficit/ budgetary deficit—refers to the amount by which government planned expenditure exceeds the expected revenue in a given financial year.

Advantages of deficit budget

1. Deficit budgeting lifts the economy out of a depression. This is through increasing government expenditure to stimulate demand, boosting production and employment.
2. Reduces the burden of taxation on the citizens of the country. The government is forced to look for other sources of funds other than relying on taxation alone.
3. Encourages participation of foreign capital in the economy.
4. Encourages government to undertake some big developmental projects which could not have been undertaken with balanced budget.
5. A deficit budget raises aggregate demand in the economy. This is through imposing low taxes on people and thus increased purchasing power and greater multiplier effects.
6. Accelerates the rate of economic growth i.e. persistent increase in the volume of goods and services. This is by encouraging private savings and investment in an economy.
7. Wins political support for the government, through reduced taxes and increased government expenditure.

Disadvantages of deficit budget

1. Results into inflationary tendencies, since it leads to increase in money supply in the economy through high government expenditure.
2. Worsens the balance of payment problems especially due to external borrowing to finance the deficit budget. Debt servicing leads to high expenditure abroad.
3. Results into external dependence i.e. dependence syndrome on foreign aid finance the deficit budget.
4. Leads to greater outflow of resources especially at the time of paying back the funds borrowed to finance the deficit budget.
5. May also encourage wastage i.e. spending more than one's ability or earnings.
6. Expected funds to finance the deficit budget may not come in time and this makes planning difficult.

Ways of financing budgetary deficits

- a) borrowing from the central bank
- b) borrowing from external sources
- c) soliciting for donations and grants
- d) selling of government securities/ borrowing from the public
- e) use of foreign reserves
- f) sale of government enterprises to raise revenue/ disinvestments
- g) use of profits from government commercial ventures
- h) use of special assessment
- i) use of compulsory savings
- j) printing of more money by the central bank

(Explain these)

Causes of Uganda's persistent budgetary deficits

1. **High population growth rate in the country.** This puts pressure on government resources by providing social services such as on education and health services; which expenditure exceeds tax revenue.
2. **Huge foreign debt repayment and debt servicing.** The repayment of the foreign debts with interest takes a big / substantial percentage of the Gross Domestic Product causing budgetary deficits.
3. **Government undertaking of ambitious projects without careful planning.** Such as universal primary and secondary education, good health for all—which raise the government expenditure.
4. **The narrow tax base and low taxable capacity.** There is a limited range of activities on which taxes are imposed and many people have low incomes, resulting slow growth of revenue yet expenditure is steadily increasing.
5. **Weak tax administration, hence high tax evasion, and avoidance.** Some tax officials are not effective leading to limited government revenue which inadequate to finance the expected revenue.
6. **The rising rate of inflation (over the years)** which disrupts government budgeting. This is partly explained by the prolonged drought which negatively affects agricultural production and reduces hydro electricity generation.
7. **Endless political insecurity in some parts of the country.** This results into rising military expenditure , expenditure on the displaced people etc not readily financed by the tax revenue.
8. **Rising costs of infrastructural development** such as power and energy, transport and communication network. There is reconstruction and rehabilitation of various networks going on all over the country. This increases public expenditure yet revenue collections are low.
9. **Ever rising expenditure on big government delegations** such as officials visiting outside countries/ foreign missions. Also increasing number of visiting foreign dignitaries not budgeted for (some with little tangible benefits to the country). All these result into increasing government expenditure (yet the revenue is limited).
10. **Existence of large/widening civil service and many unnecessary government bodies.** These bodies are rather unproductive/less productive but just raise government expenditure to facilitate their existence.

11. The unreliable and unpredictable donor support. The national budget greatly depends on foreign funds, which sometimes do not come or do not come in time and it comes in inadequate amounts. This disrupts budgeting creating budgetary deficits.
12. **Frequent natural disasters/hazards.** These require increased emergency funding which results into rising government expenditure exceeding the government revenue.
13. **High level of Corruption, embezzlement and mismanagement of public funds/ low levels of accountability.** Many tax officials utilize the tax revenue for their own selfish interests instead of handing it over to the tax authorities, hence leading to a decrease in government revenue. (*Funds to finance government expenditure are misappropriated into private businesses and accounts*).
14. **Limited non-tax sources of revenue.** This limits the revenue yet planned government expenditure is high and increasing.
15. Heavy expenditure on external commitments such as contributions to international organizations. These result into increasing government expenditure yet the tax revenue is limited.

Possible solutions/ remedies to budgetary deficits in developing countries

Note: The real solution to budgetary deficits is to reduce government expenditure and/or increase revenue collections. However when reducing government expenditure care must be taken not to lower economic growth.

1. **Privatization of public enterprises.** This is to reduce the need for government subsidies on inefficient parastatals (public corporations) and promotes efficiency/ accountability.
2. Community based self-help projects should be stepped up. This can raise funds for some projects.
3. **Reduce government expenditure on unproductive ventures** such as conferences, entertainment of foreign dignitaries , reduce excessive travelling of government officials abroad etc
4. Borrowing from internal and external sources as well as grants, gifts to reduce the budgetary deficits. However, the debts should have soft terms and injected in priority sectors.
5. **Emphasize cost sharing** such as in social services—education, health services between the public and private sectors. This reduces government expenditure on the provision of such services.
6. **Proper debt management** such as appealing to the major donor agencies to write off /cancel the outstanding debts or even negotiating debt rescheduling.
Also, advocate for the debt conversion and debt cancelation. This is to reduce the government expenditure on debt servicing.
7. **Fight corruption and mismanagement of public funds.** Government should ensure financial discipline, transparency and accountability as well as collective responsibility by all stakeholders such as by ensuring that convicted officials pay back public funds.
8. **Improve on the political climate in various parts of the country/Restore of peace, security, law and order in all parts of the country.** This can be through peace talks and dialogue. This can reduce military expenditure and such related expenses.
9. **Diversify the economy.** For example by encouraging industrialization in order to increase the range of activities on which taxes can be imposed , thus increasing government revenue.
10. Reorganization of the taxation system to widen the tax base in order to increase tax collections.

11. Reorganization of the civil service into a small and efficient one reduces public expenditure such as retrenchment, retraining programs. There is need to reduce the cabinet and parliament positions to increase efficiency and reduce government expenditure.
12. **Emphasize population control measures** such as the use of family planning methods. This reduces the population growth rates and thus reduce government expenditure on the provision of social services for the growing population.
13. **Encourage training of local manpower to equip it with the required skills.** This reduces the government expenditure on foreign expatriates.
14. **Encourage training personnel for tax assessment and collection.** This is to improve tax administration and increase government revenue from taxation.
15. **Sensitize the masses about the importance of paying taxes** such as through seminars, over radio and television. This is to change people's attitudes towards the payment of taxes, hence increasing government tax revenue.

Fiscal policy

Refers to a deliberate government policy involving the variation of government expenditure, taxation and borrowing in order to achieve desirable development objectives.

Instruments of fiscal policy

The major tools of fiscal policy are: taxation, government expenditure and public borrowing.

Objectives / roles of fiscal policy in developing countries

1. To promote investment in the public and private sectors of the economy. This through promoting high savings and MPS , tax holidays, subsidies.
2. To promote economic growth and development.
3. To reduce unemployment and under employment such as public expenditure increased on social and economic infrastructure.
4. To redistribute national income and reduce income inequality for example progressive and broad based tax structure.
5. It is a tool of economic stability i.e. maintaining economic stability. To achieve price stability
6. To minimize inflation in the economy/ to achieve price stability.
7. To correct BOP disequilibrium.

Note:

- (a) **Expansionary fiscal policy**—occurs when the government lower taxes and increases its spending, hence increasing aggregate demand and expanding output.
- (b) **Restrictive (contractionary) fiscal policy**—occurs when the government raises taxes and reduces its expenditure, hence reducing aggregate demand. It is intended to discourage spending and economic activity such as by controlling inflation. It is sometimes called **a deflationary/tight fiscal policy**.