S6 ECONOMICS.

PUBLIC FINANCE AND FISCAL POLICY

PUBLIC FINANCE:

This is concerned with various sources of public revenue and various areas where the state/government spends money in order to achieve the major objectives of national development.

OR. It is a field of study which deals with revenue raising and expenditure activities of the government/state.

PRIVATE FINANCE: This is a method of providing funds for major capital investments where private firms are contracted to complete and manage the projects.

Public finance has four major divisions/ the scope of Public finance

1. **Public revenue**: This refers to total income raised by government from various sources such as taxes, licenses, fines etc. This part looks at methods of raising public revenue and principles to be followed in taxation, effects of taxation, challenges faced by tax authorities and measures taken.

2. **Public/government expenditure**: This refers to spending by the government of a country on public services such as: education, health, provision of safe and clean water, road development, electricity etc. Public expenditure concerns the study of principles and effects of government spending on production, employment, income distribution.

3. **National debt/ public debt/ Government borrowing:** refers to the total borrowing by the state, local authorities and public corporations. This area studies causes, methods and effects of public borrowing as well as public debt management

4. **The National Budget/ Finance administration:** A national budget is an estimate of planned revenue and estimated/ planned government expenditure in a given financial/fiscal year. Finance administration includes preparation and sanctioning of government budget, auditing etc.

The need for public finance

- To provide security to the citizens so as to protect them from external and internal aggression.
- To provide relief to the poor, the depressed and victims of natural disasters so as to maintain self-esteem.
- To provide social and economic infrastructure so as to facilitate economic activities.
- To enable the state undertake ventures where the private sector cannot invest due to high capital requirements, for example, in the provision of safe and clean water.
- To enable government provide merit goods which are deemed intrinsically necessary for the society.
- To enable the state establish state monopolies which can minimize wasteful competition in the private sector.
- To promote fair distribution of income among different groups, regions and sectors. This is done through progressive taxation on the prosperous rich people and subsidization of the poor.
- To enable government influence people’s attitude through mass mobilisation and education.

Role of public finance in the development of an economy

Public finance plays/performs the follows roles.

- **It influences the level of investment**. This is through fiscal policy of reducing indirect taxes which reduces cost of production and also increasing government expenditure in the economy hence attracting more investment.
- **Raises/Mobilises revenue for the government**. This is done through imposing various taxes on various sectors of the economy. The revenue raised is used to finance government expenditure.
- **It controls the consumption of undesirable/harmful products**. This is achieved by raising taxes on such products to discourage their consumption because they become less affordable. Such products include cigarettes, alcohol etc.
- **Controls inflation/ Ensures price stability**. This is achieved through increasing taxes on people's incomes so as to reduce their disposable income and reducing government expenditure to reduce money in circulation all of which reduce the purchasing power/demand hence controlling inflation.
- **Fights unemployment in the country**. This is achieved through increased government expenditure on public works and different sectors of the economy and provision of investment incentives such as subsidies, these attract more investment in the country and thus create more employment opportunities
- **Improves the balance of payment position/reduces the country's balance of payment deficit.** This is achieved through imposing high tax on imports to reduce their inflow in the country thereby reducing the level of foreign currency outflow and thus improve the balance of payment.
- **It facilitates economic growth.** This is achieved by increasing government expenditure and reducing taxes on different sectors of the economy which motivates investors to increase investment levels thus achieving high rates of economic growth.
- **It facilitates protection infant domestic industries against unfair foreign competition**. This is achieved by imposing heavy taxes on imports which makes them expensive in the domestic market thus nationals switch to domestically produced goods this helps the domestic firms to expand/grow.
- **Controls monopoly power**. This is achieved through imposing specific and lump sum taxes on monopoly firms
- **It reduces income inequality**. This is done through imposing progressive taxes where high income earners are taxed highly and the low-income earners are taxed less and the revenue generated is used to subsidise the goods consumed by the poor
- **Promotes balanced regional development**. Balanced regional development is achieved by taxing already developed regions and increasing government expenditure in underdeveloped regions.

PUBLIC/GOVERNMENT EXPENDITURE: This refers to spending by the government of a country on public services such as: education, health, provision of safe and clean water, road development, electricity and so on. Public expenditure increases the level of investment through a multiplier effect on economic activities

Objectives of government expenditure:

- To provide basic social services for instance medical care, sanitation and education.
- To ensure internal security and defense as well as general administration.
- To influence the level and direction of economic activities through regulation of prices, balance of payments position, incomes etc.
- To cater for the unforeseen circumstances for instance floods, prolonged drought, landslides.
- To pay back the principle sums of money borrowed and interest.
- To participate directly in production and marketing of goods e.g. through establishing public enterprises.
- To redistribute income and wealth through taxation and public spending.

The composition of government expenditure in Uganda

- Expenditure on defense and related activities.
- Expenditure on development of social and economic infrastructure e.g. road network.
- Payment of wages and salaries of civil servants.
- Expenditure on education for instance UPE and USE, higher institutions of learning.
- Expenditure on public health and immunization.
- Expenditure on agricultural research and extensions for instance PMA.
- Expenditure on poverty alleviation programmes.
- Expenditure on debt servicing for instance repayment of principle sum borrowed and interest.
- Transfer payment expenditure for instance pension to the retired civil servants, bursaries to students, emergence situations like floods and landslides.

Principles/canons or guidelines of government expenditure:

- **Principle of sanction**. No public expenditure should be done without authorization by a responsible guiding body for instance parliament.
- **Principle of economy**. Public expenditure should be carried out at reasonable costs and thus discourage wastage of scarce public resources.
- **Principle of elasticity / flexibility**. There should be possibility of expanding or reducing expenditure to suit prevailing conditions in a country.
- **Principle of maximum social benefits**. Public expenditure should be beneficial to all citizens without discrimination or marginalization.
- **Principle of sound financial administration**. Public accounts must be kept and maintained accurately to avoid fraud.
- **Principle of surplus.** Government should try to avoid budgetary deficits through spending wisely.

CATEGORIES OF PUBLIC EXPENDITURE:

1. Recurrent expenditure (of government)/ consumption expenditure/Operating expenditure: This is **the day- to- day spending** of government aimed at **maintaining existing capacities**, for example payment of wages and salaries of civil servants, interest on the nation's debts, rates and rent, travel abroad and periodic contributions to international organisations.

2. Development (by government)/capital expenditure: This is the expenditure by government on **the establishment of projects** for purposes of **expanding existing capacities** and **creating new ones** to generate more goods and services, for example expenditure on setting up of medical centers, schools, power dam projects, road and other forms of infrastructure.

3. Transfer payment expenditure: This is any expenditure by the government where there is **no corresponding goods and services in return,** for instance payments in form of old age pension, unemployment allowances, bursaries to students, spending on natural disasters.

Factors that influence public expenditure:

- **Level of infrastructural development**. Increase in the level of development of infrastructure increases public expenditure as government strives to put up the required infrastructure while a reduction in the level of development of infrastructure reduces public expenditure since there is minimal pressure to put up infrastructure.

- **Degree of natural calamities and emergencies**. Increase in the degree of natural calamities and other emergencies increases public expenditure through provision of relief items like food, clothes and shelter while a reduction in the degree of natural calamities reduces public expenditure since there are less or no relief requirements to spend on.

- **Level of expenditure on defence or political climate**. Political instability increases public expenditure through purchase of firearms and other military related activities so as to ensure political stability while political stability reduces public expenditure on defense because of peace prevailing in the country.

- **The population growth rate**. Increase in population growth rate increases dependence hence an increase in public expenditure as government strives to meet the required social services while a reduction in population growth rate reduces public expenditure because of reduced dependence.
- **Level of government effort to eradicate poverty**. Increase in the level of government effort to eradicate poverty through increased incomes increases government expenditure because of increased obligations while a reduction in the level of government effort to eradicate poverty reduces public expenditure because of reduced obligations.
- **The rate of inflation in the country**. Increased rate of inflation leads to increase in government expenditure due to increase in cost of putting up the required projects while a reduction in the rate of inflation reduces public expenditure due to a decrease in the cost of putting up the required projects.
- **The size of public service [size of cabinet or administrative costs].** Increase in size of parliament, cabinet and public service leads to increase in public expenditure in form of salaries, wages and allowances while a reduction in size of public service reduces public expenditure.
- **Level of expenditure on settling public debt**. Increase in public debt leads to increased debt burden leading to increased public expenditure to settle the public debt while a reduction in public in public debt reduces the debt burden hence less public expenditure.

- **Level of international commitments and engagements.** An increase in the level of international commitments e.g. contributions to international organizations and diplomatic missions increases public expenditure while a reduction in the level of international commitment reduces public expenditure because of reduced international obligations.
- **Level/degree of external visits by government officials**. Increase in the level of state visits by government officials' increases public expenditure in an attempt to finance these visits while a reduction in the level of state visits reduces public expenditure.
- **Level of accountability**. Increase in level of corruption increases public expenditure in an attempt to fight it while a reduction in the level of corruption reduces public expenditure because of proper accountability of public funds.

CAUSES OF INCREASE IN PUBLIC EXPENDITURE IN UGANDA:

- **High population growth rate**. This calls for calls for increased spending by government on social services like provision of clean and safe water, education, health services.
- **Rising defense expenditure due to increasing social and political instability.** This calls for heavy expenditure on the military sector so as to restore peace in the country.
- **Increasing expenditure on the settlement of public debt.** This is in terms of paying back both the principle sums borrowed and interest.

- **High rate of inflation**. This leads to rising costs of project implementation hence increasing government expenditure.

- **Increasing levels of administrative costs**. Such costs are caused by increasing size of public service, creation of new districts, frequent by-elections, large number of state cabinet ministers and members of parliament hence increased government expenditure.

- **Rising emergency funding due to frequency of natural hazards.** The frequent occurrence of natural hazards such as landslides, floods, prolonged drought necessitates provision of relief items like food, blankets, clothes all of which call for increased government expenditure.

- **Rising levels of corruption/ embezzlement by public officials/ rising costs of fighting corruption.** This necessitates setting up of institutions such as inspector general of government, public accounts committee and commission of inquiry so as to curb corruption among government officials, establishment of such institutions lead to increasing government expenditure.

- **Rising costs of infrastructural development.** The increasing infrastructural development and rehabilitation of dilapidated infrastructure such as roads, power dams, hospital, schools etc. is leading to increasing government expenditure.

- **Rising expenditure on international commitments.** This is leading to increasing expenditure by the government on subscriptions fees in international organisations such as African Union, United Nations, and East African Community.

- **Continuous over ambitious economic planning.** This means that the government tends to do too much in a so short time which calls for increasing expenditure.

- **Rising government expenditure on programmes to create employment, incomes etc.** This is calling for increasing government expenditure on public works and subsidizing the potential investors so as to stimulate investment and thus create more jobs.

- **Rising administrative costs due to increasing size of the public service, new districts, frequent by elections, large cabinet and parliament.** All these are leading to increasing government expenditure.

Positive effects of increased government expenditure

- It increases incomes of people in the country hence improved welfare.
- It leads to increased demand for goods and services due to increased purchasing power.
- It leads to increased production of goods and services due to increased aggregate demand.
- It leads to development of both social and economic infrastructure in the country e.g. hospitals, schools, roads, power dam projects.
- It increases on employment creation due to increased investment and production.
- It leads to improvement in political climate of the country hence increased economic activity.
- It promotes commercialization of the economy through reduced dependence on subsistence production.
- It leads to increased government revenue due to increased investment in the country.

Negative effects of increased government expenditure

- It may be inflationary when increased public spending is not corresponding with increase in the level of output.
- It worsens debt burden especially when government expenditure is dependent on foreign resources/funds.
- Government expenditure directed towards non-productive activities creates shortage of essential goods and services.

Measures that can be taken to reduce government expenditure:

- **Negotiate for waiving of debts**. This will reduce expenditure in form of debt servicing and repayment of the principle hence reduces public spending.

- **Seek for debt rescheduling**. This aims at postponing the payment of some debts to future date which reduces debt burden and government expenditure on debt servicing.

- **Acquire concessional loans/ grants**. The concessional loans attract low interest rates hence help to reduce debt burden.

- **Revise government expenditure**. The government should spend money only on priority sectors that are of economic importance or projects that are self liquidating.

- **Strengthen management of public funds**. This aims at intensifying fight against corruption through setting up and empowering anti-corruption institutions e.g. IGG, Auditor general and PAC to punish those public officials found guilty.

- **Merge ministries and government departments.** This aims at reducing expenditure on many ministries and departments thus increasing investment in productive infrastructures.

- **Introduce cost sharing hospital and high institutions of learning**. This aims at increasing expenditure in other sectors of national importance which increases on the volume of output.

- **Employ local personnel instead of expatriates**. This will reduce excessive expenditure on expatriates.

- **Reduce expenditure on foreign missions**. This is either by closing some of the foreign missions and/or reducing foreign mission staff.

- **Ensure political stability**. This aims at reducing heavy military expenditure hence increasing level of economic activities which are self liquidating.

- **Control population growth rate**. This aims at reducing high dependence burden hence reducing government expenditure on provision of social services.

- **Privatise non-performing state enterprises**. This will reduce the heavy expenditure by the government on subsidising such inefficient enterprises and thus reduce government expenditure.

SOURCES OF PUBLIC FINANCE:

There are mainly two sources of public finance which include **tax revenue sources** and **non-tax revenue sources.**

A: TAX REVEUNUE SOURCES: These involve the government imposing taxes on people's incomes or on goods and services

Definition of (i) **Tax:** This is a **compulsory** payment/ contribution levied by a public authority (government) irrespective of the exact amount of services rendered to the payer in return.

OR: It is a non-quid-pro-quo **compulsory** payment imposed by a public authority on an individual or a business entity.

(ii) Taxation: This is the means by which government finances its expenditure by imposing taxes on individuals or business firms.

OR: It is a system by which a government takes money from people and spends it the provision of social services and infrastructure

B. NON-TAX SOURCES: These refer to other sources of government revenue other than taxation. Such sources are managed by city councils, municipalities and districts, and they include the following:

- **Fees**: These are payments made by individuals to public authorities for services rendered to them by the state. For example, valuing property, weighing vehicles, stamp duties, surveying land, parking fees.

- **Fines and penalties:** These are payments made by individuals for contravening the laws of a country e.g. traffic fine for overloading, over speeding, possession of expired driving permit etc.

- **Gifts and grants**: These are voluntary contributions made to the government by individuals, organisations and friendly countries to meet the cost of specific projects in public interests e.g. World Health Organization, Global fund etc.

- **Market dues**: These are payments made by individuals to public authorities so as to get permission to sell one's products in a particular market. The dues are used for maintaining good standards in the market such as cleanliness, fencing and to meet other public expenditure needs.

- **Borrowing/ Loans**: This is usually a temporary source of public finance where the state acquires loans either from within or outside the country e.g. World Bank and IMF.

- **Gambling:** This is payment on a voluntary basis through purchase of raffles as a way of mobilising savings by organising national lotteries. Surplus funds from gambling activities help in financing a budget.

- **Profits/proceeds from government productive activities**: Government can finance its budget by using proceeds earned from its productive activities like those performed by public enterprises e.g. National water and Sewerage.

- **Compulsory saving schemes or payments**: These are contributions made by private sector employees to the government with an aim of saving for the future and they act as public finance e.g. social security contributions made to National Social Security Fund.

- **Privatisation /Disinvestments/ Proceeds from the sale of government enterprises**. Government earns revenue from selling its property at home and abroad and such revenue is used to finance its budget e.g. sale of Uganda commercial bank

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- **Rent on government owned property**: These are payments made to the government for occupying its property for example, public halls, housing estates, land and such payments are used to finance the budget e.g. payments made to municipal authorities as land rent

- **Rates**: This is the money realised by the government for the use public utilities offered by the government e.g. piped water, sewerage disposal, electricity etc.

- **Licenses**: Licenses are payments made to the government by an individual to secure permission to operate business or any other gainful activity e.g. trading license.

- **Bridge/road toll:** This is payment made by an individual to have right to cross a bridge or use a road at some point.

- **Forfeitures**: These are properties given up to the government due to failure to legally claim them within the time period prescribed by the law. E.g. importers who fail to clear tariffs on goods imported, property seized from smugglers by revenue authority of a country.

- **Special assessments**: This refers to the amount of money charged on particular individuals for a specific purpose. E.g. compulsory contribution on parking places of vehicles.

METHODS OF EXPANDING THE SOURCES OF GOVERNMENT REVENUE:

1. **Undertake tax diversification**; The government should find a variety of tax bases/ sources so as to widen the sources of government revenue from taxes.
2. **Widen non- tax sources**. Government should identify more non -tax sources of revenue, which will enable her to raise more money from such sources.

FISCAL POLICY

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

THE OBJECTIVES OF THE FISCAL POLICY:

- **To raise government revenue.** This is achieved through taxation.
- **To increase/ accelerate the rate of economic growth:** The government uses the available fiscal policy tool to mobilise more resources for investment, as well as direct the resources to those channels where their yield is higher and the goods produced are socially acceptable to realise rapid economic growth and development.
- **To reduce the inequality.** This is achieved by taxing the rich and subsidising the poor.
- **To create more employment opportunities**. This is achieved by using fiscal incentives, in the form of tax holidays, subsidisation of producers so as to increase investment in different sectors of the economy for example the industrial sector that has a high potential to generate employment.
- **To ensure price stability in the economy.** This is achieved through increasing direct taxes on people's incomes to reduce the excessive aggregate demand over supply and also reduce government expenditure to reduce high rate of inflation and during a deflationary tendency the government reduces direct taxes on people's income and increase government to stimulate aggregate demand in the economy.
- **To discourage consumption of demerit goods**. This is achieved through imposing high taxes on such goods which makes them less affordable and thus making people to abandon their consumption.
- **To improve the balance of payment position**. This is achieved by providing tax concession to export oriented industries to increase the volume of exports and export earnings and also by discouraging imports through imposing heavy taxes on them.
- **To protect infant/ domestic industries.** This is achieved by use import duties which help to reduce the inflow of imports and thus preserve the market for domestic producers.
- **To achieve balanced regional development**. This is achieved by taxing the already developed areas and increasing government expenditure in underdeveloped areas.
- **To achieve the desirable political objectives**. This is achieved through tax reductions, reliefs/ exemptions where the members of the public feel that the government cares about them and this makes the government popular.
- **To improve incomes and quality of life of the population**. This is achieved by increasing government expenditure on provision of social services.
- **To control monopoly power.** This is achieved through high taxation on their abnormal profits and increased subsidisations of other firms to enable them compete effectively with monopolists.
- **To influence resource allocation.** This is achieved through giving tax holidays/relief and tax exemptions.
- **To achieve desirable political objectives.** This is through tax reductions, relief and exemptions.

INSRTUMENTS/ TOOLS OF FISCAL POLICY:

- **Taxation.** Government reduces taxes on such activities in order to promote them and it increases taxes on those activities that she wants to discourage.

- **Government expenditure.** Government increases her expenditure to encourage an activity, whereas it reduces her expenditure when there is need to discourage a certain activity.
- **Subsidisation.** Government offers subsidies order to encourage a given activity by reducing the cost of production and denies subsidies when there is no need to encourage a given activity.
- **Fees.** Government raises fees to discourage people from accessing certain services such as passports and reduces fees in order to encourage people to access certain services provided by the government

- **Fines.** The government raises fines to discourage people from contravening laws of the country in order to keep law and order.
- **Licensing.** Government raises license fees in order to discourage establishment of certain economic activities, but lowers the license fees in order to encourage people to carry out certain activities.
- **Public borrowing.** Government borrows in order to support economic activities by injecting more money in the improvement of infrastructure, on the other hand government reduce borrowing in case it wants to discourage certain economic activities.
- **Debt repayment.** Through debt repayment the government increases the amount of money in circulation which stimulates aggregate demand and thus stimulates economic activities in the country.
- **Public disinvestment/ Privatisation.** This reduces government expenditure on subsidisation of inefficient state enterprises and at the same time promotes private investments through transfer ownership of such enterprises to private individuals.

PRINCIPLES/CANONS OF TAXATION:

These refer to the rules that guide the public authority in assessment, collection and administration of taxes.

These principles include the following:

- **Principle of equity.** The burden should fall equitably on the tax payers. Therefore, those individuals with high incomes should pay more than those with low incomes. Equity may be horizontal or vertical:

  (a)Horizontal equity. Horizontal equity is where people in the same income bracket pay the same amount of tax during tax assessment.

  (b)Vertical equity. Vertical equity is where people in different income bracket pay different amount of tax during tax assessment.
- **Principle of certainty:** Taxpayers and tax collectors should be aware of the tax base, amount of tax to pay and the time of payment of the tax to avoid misunderstandings between tax administrators and taxpayers.
- **Principle of convenience.** The tax levied should be collected in the form, method and at the time that is convenient, easy, and comfortable for the taxpayer to pay
- **Principle of economy /efficiency or cheapness.** The tax should be economical in the sense that the cost of assessment and collection should be lower than the revenue realised. The cost should not exceed 5% of the revenue realised.
- **Principle of productivity:** The tax imposed should yield high government revenue, and it should not discourage investment.
- **Principle of elasticity /flexibility or buoyancy.** Tax elasticity measures the automatic response of tax to income changes. A good tax system should be flexible in the sense that the government should be able to increase or reduce the tax with ease according to the economic situation, for example, it should be easy to increase it during an economic boom as income rise and reduce it during a recession, or depression as income falls.
- **Principle of simplicity.** The tax imposed should be easy to understand and calculate by both the tax collector and the taxpayers to avoid misunderstanding and corruption

- **Principle of neutrality/ impartiality.** The tax should be impartial in the sense that it should not discriminate among taxpayers. All taxpayers should pay the tax they are liable to pay.
- **Principle of diversity /comprehensiveness.** A good tax should have a wider source or base so as to increase revenue, minimize tax avoidance and evasion. In other wards there should be a variety of taxes on different tax bases to ensure high yield and reduce uncertainty of tax yield.
- **Principle of consistency.** A good tax system should be in line with the economy's national economic and social objectives. For example, if the economic objective is to reduce the income gap, then a progressive tax should be levied.
- **Principle of ability to pay.** The tax payer should be able to pay tax assessed on him/her with ease so that she/ he is in position of remaining with enough disposable income to live a decent life after paying tax.
- **Avoidance of double taxation principle.** A single tax base should not be taxed more than once so that the individuals do not resist tax. In other wards a tax should not be imposed on the same source or base more than once.

Characteristics/ Features of a good tax system:

Whereas canons/ principles are guidelines to be followed in tax assessment, the characteristics of a good tax system looks at what it should be in order to yield the tax revenue desired in the economy, these include the following.

- It **should be consistent** i.e. it should be line with the national economic objectives.
- It **should be comprehensive** i.e. a good tax system should cover a variety of tax bases, should have a wider source/cover many areas.
- A good tax system **should be simple** i.e. it should be easily calculated and understood.
- It **should be impartial/neutral** i.e. it should not be discriminative amongst the tax payers.
- It **should be flexible/elastic** i.e. a good tax should be altered/adjusted according to the prevailing economic conditions.
- A good tax system **should productive** i.e. should be able to encourage effort, initiative and hard work and should not discourage investment.
- A good tax system **should be efficient** i.e. tax assessment and collection should be effected with a lot of administrative ease.
- A good tax system **should be economical/ cheap/ efficient.** i.e. the cost of tax administration, assessment and collection should be low.
- A good tax system **should avoid double taxation** i.e. individuals should not pay a tax twice under one tax base.
- A good tax system **should be certain** i.e. one whose base, time of payment, amount to be paid etc are known.
- A good tax system **should be convenient** i.e. when and where to pay a tax should be convenient to the tax payer.

- **It should be optimal**. A good tax system should ensure that there is a minimum balance between the amounts of revenue collected, the services rendered and work effort of tax payers.
- It **should be equitable/fair/ ability to pay.** i.e. the burden of payment should fall equitably on all tax payers.
- It **should be optimal** i.e. there should be a minimum balance between the amount of revenue collected, the services rendered and work effort of the taxpayer

REASONS FOR IMPOSING TAXES IN AN ECONOMY:

To raise revenue for the government. The government realises more revenue by increasing the taxes and this enables the government to finance its obligations i.e. paying civil servants, infrastructural development, providing security etc.

To reduce income and wealth inequality/ to ensure equitable distribution of income. This is achieved by using progressive taxation where the rich are taxed more the poor and the revenue generated is used to subsidise the services consumed by the poor.

To protect infant domestic industries against foreign competition. This is achieved by increasing import duties to discourage importation of goods and therefore preserve the market for domestic producers.

To improve the balance of payment position/to correct the B.O.P deficit. This is achieved by imposing heavy taxes on imports to make them more expensive and discourage their consumption in the country and thus help to reduce foreign exchange expenditure on such goods.

To discourage the production and consumption of certain undesirable/harmful/ demerit goods such as alcohol, cigarettes. This is achieved by increasing taxes on such commodities to make them more expensive and thus discourage buyers since they become less affordable to them.

To discourage emergence of monopoly power and its associated evils. This is achieved by taxing the super normal profits of monopoly firms.

To ensure steady economic growth. This is achieved through subsidisation and provision of other tax incentives which attracts investments in different sectors of the economy leading to increased volume of goods and services produced and thus high rate of economic growth.

To influence investment/ to ensure proper allocation of resources. This is achieved by reducing taxes or giving subsidies to sectors/ activities where government wants to direct resource allocation or impose high taxes to discourage investment in certain economic activities.

To control the level of inflation/to fight inflation. This is achieved by increasing direct taxes on people's incomes so as to reduce their disposable income and thus reduce the excessive aggregate demand over supply and thus reduce the general price levels.

To control dumping. This is achieved by imposing high taxes on imports being dumped into the country and thus reduce their inflow and their associated effects on the receipient economy.

To encourage hard work and initiative/ effort. By increasing direct taxes on people's income, it encourages them to work hard so as to get money to pay taxes. High indirect taxes also encourage people to work hard in order to get money to catch up with the rising cost of living.

Merits of levying taxes in an economy:

- **Taxes increase public revenue**. The taxes imposed on different economic activities and on people's incomes enable her to generate high level of public revenue which it uses to meet her recurrent and development expenditures.
- **Taxes ensure equitable distribution of income**. Through imposing progressive taxes, the government taxes the rich more than the poor and the revenue generated is used to subsidise goods and services consumed by the poor.
- **Taxes improve the balance of payments position**. This is achieved by imposing very high import duties/taxes which their reduce their inflow and thus help to reduce foreign exchange expenditure on such imports, leading to improvement in the balance of payments position.
- **Taxes help to protect domestic producers/firms**. High taxes imposed on imports makes them very expensive and therefore less affordable to the nationals, this compels them to resort to domestically produced goods and according market to local firms which enables them to grow and expand.
- **Taxes ensure proper allocation of resources/influence investment**. Provision of tax incentives such as subsidies attracts investment in particular economic activities which are favoured by the government.
- **Taxes control the rate of inflation in an economy**. Imposition of high direct taxes on people's incomes reduces the disposable incomes, leading to a fall in aggregate demand for goods and services and thus controlling inflation in the economy.
- **Taxes discourage the production and consumption of undesirable/demerit goods such as cigarettes, alcohol.** Imposition of high indirect taxes on demerit goods makes them less affordable to people and thus force many people to abandon such goods.
- **Taxes influence the level/rate of economic growth**. Provision of tax incentives attracts many people to invest in different economic activities which lead to an increase in the volume of goods and services produced and thus leading to high rate of economic growth.
- **Taxes regulate monopoly power and its evils**. The supernormal profits of the monopolists are taxed, which discourages them since it increases the cost of production and thus reduce their profit margin.
- **Taxes control dumping**. Imposition of taxes discourages dumping in the recipient country because prices of those goods increase and thus makes people to abandon them in preference to domestically produced goods. This helps to reduce the evils of dumping in an economy.
- **Taxes encourage hard work and initiative/effort**. Imposition of high direct taxes encourages people to work hard in order to get the money to pay the taxes imposed on them and at the same time high indirect taxes leads to high cost of living which forces people to work hard so as to catch up with the rising cost of living.

Demerits of levying taxes in an economy:

- **Discourages savings**. This is because high direct taxes reduce people's disposable incomes and thus they are left with less amount of money for consumption and savings.
- **Encourages malpractices such as smuggling, corruption**. High import duties encourage smuggling as importers avoid going through the proper customs posts so as to avoid paying high taxes on imports.

- **It is inflationary** (the case with indirect taxes). High indirect taxes lead to increased costs of production, which are pushed to consumers in form high prices for final goods, this leads to inflationary tendencies in the economy.
- **Discourages effort and initiative** of people to work harder. This is because extra incomes the people are taxed highly in case of progressive taxation.
- **Creates resentment of the government that may erode her popularity/leads to unrest by the tax payers/ traders.** This is because high taxes reduce the profits of the traders due to high cost of production and on the part of the consumers it leads to reduced welfare due to high prices of commodities.
- **Limit the volume and benefit of trade/ leads to retaliation in trade.** This is because high import duty discourages the inflow of the goods in the country, the limits the variety of goods in the economy.
- **Leads to diversion of resources from highly taxed to at times non-productive activities that are less taxed/ Leads to misallocation of resources.** e.g. excise duty.
- **Reduces consumer welfare due to reduced consumption** of commodities that are highly taxed.
- **Discourages investment**. This is because high indirect taxes increase the costs of production and thus reduce the profitability of doing business.
- **Increases production costs leading to closure of some firms**/ reduced producer profits/ Unemployment due to closure of loss-making firms.

Positive role of taxation:

- **It is a means of acquiring government revenue**. Revenue is realized through taxation on economic activities and this enables the state to perform its duties to the public.

- **It ensures equitable distribution of income**. This is through use of progressive taxation on the more prosperous/ the rich, while increasing government expenditure on the poor.

- **It improves balance of payments position.** This is through imposition of high taxes on imported commodities and reduced taxes on exports.

- **It controls inflation** This is through imposing high taxes on people's incomes which reduces their disposable income, this reduce the excess aggregate demand over supply thus curbing inflation

- **It ensures proper resource allocation/influences investment**. Taxes are reduced to encourage investment in certain activities and increased to discourage investment in certain activities.

- **It discourages production and consumption of demerit goods** as: alcohol, drugs, and cigarettes. This is so because imposition of taxes on such goods makes them very expensive and thus less affordable to people who abandon them.

- **It influences the level of economic growth**. This is through provision of tax incentives to encourage investment and direct the growth process to priority sectors.

- **It is a means of protecting domestic/ infant firms/ industries**. Domestic firms are protected from unfair competion by foreign firms through imposing high tariffs on imported commodities which reduces their inflow in the country and thus the market is preserved for the domestic firms.

- **It regulates/ controls monopoly power**. This is through imposition of high lump-sum and specific taxes on monopoly profits.

- **It is a means of controlling dumping**. This is through imposition of high taxes on low priced imported commodities hence reducing competition with locally produced commodities.

- **It encourages hard work and initiative/effort**. The high prices of goods and services resulting from taxation compel people to work hard so as to acquire money to meet the rising cost of living.

- **It is a means of forced savings**. Because of high taxes, consumers are unable to spend on desired commodities hence more money is saved.

NEGATIVE ROLE OF TAXATION:

- Discourages savings.
- Encourages malpractices such as smuggling, corruption.
- It is inflationary
- Discourages effort and initiative of people to work harder.
- Creates resentment of the government that may erode her popularity/leads to unrest by the tax payers/ traders.
- Limit the volume and benefit of trade/ leads to retaliation in trade.
- Leads to diversion of resources from highly taxed to at times non-productive activities that are less taxed/ Leads to misallocation of resources.
- Reduces consumer welfare due to reduced consumption of commodities that are highly taxed.
- Discourages investment.
- Increases production costs leading to closure of some firms/ reduced producer profits/ Unemployment due to closure of loss making firms.

IMPORTANCE OF TAXES IN AN ECONOMY

- **Taxes are used to acquire public revenue**. Such revenue enables the state to perform its duties to the public.

- **Taxes are used to ensure equitable distribution of income**. This is through adoption of progressive taxation on the more prosperous rich people while increasing government expenditure on the poor.

- **Taxes are used to improve on the balance of payments position**. This is through imposition of high taxes on imported commodities and reduced taxes on exports.

- **Taxes are used protect domestic producers/firms**. Domestic producers are protected from foreign competition through imposition of high tariffs on imported commodities.

- **Taxes are used ensure proper allocation of resources/influence investment**. This is through imposition of corporate taxes on all business units registered by the state.

- **Taxes are used to control inflation.** This is through imposition of high taxes on people's income to reduce their disposable income and thus reduce excessive aggregate demand over supply.

- **Taxes are used to discourage the production and consumption of undesirable/demerit goods such as cigarettes, alcohol.**

- **Taxes are used to influence the level of economic growth**. This is through provision of tax incentives to promote investment and direct the growth process to priority sectors.

- **Taxes are used to regulate/ control monopoly power**. This is through imposition of high taxes on profits of monopolists.

TYPES OF TAXES:

1. **Direct taxes:** are those taxes levied directly on **incomes** and **property of individuals** and enterprises such that the **incidence of the tax** rests on the **taxpayer** concerned and cannot be shifted to another person.

Direct taxes have got the following features:

- They are paid by individual income earners and enterprises.
- The incidence of the tax cannot be shifted to another person.
- They change with the status of the tax payer for instance they are progressive in nature.
- They are unavoidable because they are imposed on one's income or property.
- They are directly collected by the government.
- They have high cost of collection and administration since government has to employ many tax administrators.

Types of direct taxes

1. Proportional tax. This is tax whose **rate** remains constant for all levels of income. The rate of tax is the same irrespective of the size of income or size of the tax base.

Example

Taxable base (shs)	Tax rate (%)	Tax liability (shs)	Disposable income
500	10	50	450
5,000	10	500	4,500
50,000	10	5,000	45,000
500,000	10	50,000	450,000

Merits of proportional tax

- It is easy to calculate the tax liability hence satisfying the principle of certainty.
- It is simple to understand to both the tax payer and the tax collector.

Demerits of proportional tax

- It promotes income inequality as the poor pay more compared to the rich people.
- It violates the principle of productivity since the rich with enough income pay less compared to the poor people.

2. **Progressive tax:** This is one whose **rate** increases/rises as the income or spending power increases.
   An increasingly larger percentage of income is paid in tax as income increases. The tax is designed to redistribute income from high income earners to low income earners for instance, (**PAY AS YOU EARN)** scheme.

An illustration of a progressive tax.

Taxable base (shs)	Tax rate (%)	Tax liability (shs)	Disposable income
0 – 5,000	-	-	-
5,000 – 10,000	20	1,000	9,000
10,000 – 15,000	30	1,500	13,500
15,000 – 20,000	40	2,000	18,000

Reasons for imposing progressive taxes in an economy:

- To reduce income inequality
- To raise revenue for the government
- To control demand pull inflation

Merits of progressive tax

- It yields high tax revenue to the government.
- It promotes equitable distribution of income and wealth.
- It favours low income earners as they pay less compared to the rich people.
- It controls demand-pull inflation in an economy.

Demerits of progressive tax

- It discourages effort and initiative of people to work harder.
- It discourages investment among the rich people.
- It arouses resentment or political discontent.
- It discourages savings by reducing disposable income.

3. Regressive tax. This is one whose **rate** falls/ reduces as the income or spending power increases. i.e. it takes a higher proportion of income earners than high income earners.

An illustration of a regressive tax:

Taxable base (shs)	Tax rate (%)	Tax liability (shs)	Disposable income
10,000	15	1,500	8,500
20,000	10	2,000	18,000
30,000	7	2,100	27,900
40,000	6	2,400	37,600

Merits of regressive taxes

- They promote savings and investment among the rich people.
- They encourage hard work among the poor people.

Demerits of regressive taxes

- They promote/ widen income inequality between the poor and the rich.
- They discourage savings and investment among low income earners.
- They limit consumption of mass consumer goods/reduce standard of living among the low income earners.
- They limit government revenue generated by the government
- They lead to social unrest/political discontent.
- They encourage tax evasion and avoidance.

3. **Disregressive tax** is one whose **rate** increases up to a certain level of income beyond which a uniform rate is charged. It is usually progressive at lower level but proportional at higher level of income. The rich feel a relatively lesser burden since their sacrifice in form of tax is lower in relation to their income.

An illustration of a disregressive tax

Taxable base (shs)	Tax rate (%)	Tax liability (shs)	Disposable income
10,000	15	1,500	8,500
20,000	20	4,000	16,000
30,000	20	6,000	24,000
40,000	20	8,000	32,000

4. **Capital gains tax:** This is the tax levied on financial assets whose values have increased from the time of their purchase to the time of their sale
.
5. **Corporation tax or company tax**: This is a tax levied on profits of companies.
   Merits of corporation tax
   - It raises more revenue to the government
   - It helps to control monopoly power with its evils.

Demerits of corporation tax
- It discourages investments.
- It hampers ploughing back of capital.
- It encourages tax avoidance/ leads to capitalisation of a tax.
- It encourages resentment .
- It encourages tax evasion.
- It discourages innovations

6. Personal income tax is a tax imposed by the government on the income of an individual regardless of how it is earned. It is progressive in nature i.e. the higher the level of income the higher the tax which is a clear measure of ability to pay.

7. Inheritance tax is a tax imposed on inherited property and it is paid by the beneficiaries. It is intended to raise revenue and redistribute income by preventing beneficiaries from enjoying a large sum of money or property they never worked for or earned it.

8. Property tax /wealth tax is a tax levied on ones' stock of wealth or past accumulated funds. It is a means of reducing inequalities in wealth and income.

9. Capital levy is a tax imposed once and for all during national emergence situations i.e. when there are pressing needs for capital or revenue for development purposes.

10. Land tax is tax imposed to discourage or break land monopoly, leasehold system and promote development of land sites.

11. Surtax is extra tax paid on incomes beyond a certain level of income.
OR: tax payable on very high incomes exceeding specified limits and it is aimed at reducing income inequality.

12. Graduated tax/ poll tax is a tax paid by all adults or individuals above age of 18 annually. It is paid at fixed rate irrespective of income levels. It is called graduated tax because it is paid by those who graduate to 18 years of age.
13. Stamp duty is a tax imposed when there is transfer of property from one person to another.

14. Gift tax is tax charged on property or income given freely to an individual. It is a tax among the living and thus it is a means of stopping a sick person who is expecting to die soon or his heir from escaping death duty.

Merits of direct taxes in an economy

- **They enable the government to acquire public revenue**. Direct taxes are mainly progressive in nature, which enables government to realise adequate amount of tax revenue because the rich are highly taxed.

- **They promote equitable distribution of income**. This is through adoption of progressive taxation on the rich people and the revenue got is used to increase government expenditure on the poor.

- **They help to control inflation**. This is through imposition of high direct taxes on peoples' incomes which reduces their purchasing power and thus reducing the excessive aggregate demand over supply thus a fall in the general price levels.

- **They regulate/control monopoly power**. Direct taxes regulate monopoly power by the government levying high taxes on the supernormal profits of the monopolist.

- **They encourage economic growth/ Production levels.** This is through provision of tax incentives to promote investment and direct the growth process to priority sectors.

- **They influence proper resource allocation.** Direct taxes such as corporate taxes influence resource allocation, by directing resources from non-priority areas of investment to priority sectors, which enables optimal resource utilisation.

- **They encourage hard work and initiative/effort**. Direct taxes instill the spirit of hard work and responsibility among tax payers which results in an increase the level of economic activities and production in the economy as the tax payers strive to raise money to pay the tax imposed on them.

Demerits of direct taxes in an economy:

- **They discourage investment.** High direct such as corporation taxes are a disincentive to entrepreneurship and thus discouraging investment since they reduce business profits.

- **They reduce the welfare of the people**. High direct taxes reduce consumption of goods due to reduced disposable incomes of the people.

- **They discourage effort and initiative/ hard work** High direct taxes are a disincentive to hard work since additional income due to hard work is highly taxed.
- **They lead to resource diversion from highly taxed activities to sometimes non-productive ventures that are less taxed.** For example, high corporate taxes.

- **They create resentment among the people that may erode popularity of government.** People blame the government in power for levying the high taxes on their incomes that have a direct negative impact on their standard of living.

- **Direct taxes worsen/ widen income inequalities.** The poor tend to feel a bigger tax burden than the rich hence widening the income gap between them.

- **Direct taxes discourage savings**. Heavy direct taxes are a disincentive to saving. These taxes directly reduce the disposable incomes of individuals leaving them with little or nothing to save.

- **They lead to high cost of administration/ High government expenditure on collection**. This is because they are scattered and therefore very many tax administrators have to be employed in order to reach out to all the potential tax payers.

INDIRECT TAXES/OUTLAYS/EXPENDITURE TAXES/ CONSUMPTION TAXES: These are taxes that are levied on **goods** and **services** and a person who pays the tax **can shift it** to another person in form of high prices.

Indirect taxes have got the following features:

- They can be shifted by the tax payer to another person in form of high prices.
- They are voluntary payments (optional taxes) i.e. one may choose to pay or not to pay.
- They are regressive in nature i.e. the low-income earners bear a bigger burden of indirect taxes.
- They are paid knowingly and willing since they are part of price of goods and services.
- They are imposed on goods and services hence they are part of prices set.

Types of indirect taxes:

1. **Customs duty.** Customs duty is a tax imposed on either goods imported or exported. **OR:** it is tax levied on goods as they cross borders between countries.

Customs duty is categorized as:

a) Import duty is tax levied on all commodities entering a country.

Import duty can be ad- valorem duty basing on value of a good or specific duty basing on physical units of the good.

Import duty is imposed basing for the following objectives:

- To raise revenue for the government.
- To protect domestic (infant) industries from foreign competition.
- To discourage importation of luxurious and socially undesirable commodities.
- To improve the country's balance of payments position by discouraging imports.
- To reduce imported inflation
- To conserve scarce foreign exchange by discouraging imports.
- To increase on the level of employment opportunities by reducing the volume of imports.

b) Export duty is tax imposed on goods leaving the country, and it is paid at the exporting point. Export duty is imposed basing on the following objectives:

- To reduce on the volume of exports so as to satisfy the local market.
- To realize government revenue from taxation.

2. Excise duty. This is tax which is levied on locally produced commodities produced within the country whether meant for local consumption or for export, e.g. on alcoholic drinks, tobacco.

4. Octroi tax is one that is levied on goods in transit from one country through the territory of another country e. g. from Kenya to Rwanda through Uganda.

5. Sumptuary tax is a tax imposed to discourage consumption and production of particular goods especially those considered to undesirable to the society e.g. alcoholic drinks, tobacco, pornographic films. The tax is levied to discourage production and consumption on grounds of health, morality or economic consideration.

6. Sales tax is tax levied on all commodities sold in the country on retail basis whether imported or locally produced. Sales tax in Uganda was abolished in 1996 and replaced by **Value Added Tax.**

7. Value added tax. This is a tax imposed on the value added to a commodity at each stage of production or sale of a commodity.

At different stages of production there is a value that is added to a commodity however, the final price of a commodity sums up all the value added at all stages through which the commodity passes.
Value added tax is imposed on the value added to a commodity by **registered suppliers.** It is calculated by subtracting the cost of all material inputs used in production from total output of a business.

Merits of value added tax in Uganda:

- It helps to avoid double taxation. The tax payer is not taxed more than once on the same tax base or activity because it is levied at different stages of production or sale of a commodity.
- It discourages tax avoidance and tax evasion. The tax is distributed at all stages of production, and whenever there is sale of goods thus it yields high revenue to the government.
- It creates efficiency in business management. This is because it encourages proper record keeping since assessment is based on books of accounts.
- It is not a disincentive to resource allocation. The tax does not lead to shifting of resources to other sectors or activities.
- It encourages exports of a country by making them competitive. This is because there is a refund made on tax paid on inputs used to produce goods for export.
- It reduces corruption among tax officials. This is because all payment is done through the bank directly.
- It leads to increased government revenue because it is comprehensive in nature.
- It is economical in terms of administration and collection. This is because it is collected by suppliers/producers on behalf of the government hence high revenue realised.
- It does not discriminate among tax payers. This is because the tax is imposed on consumer goods and therefore paid by everyone who purchases goods.

Demerits of value added tax in Uganda:

- It is inflationary in nature. The tax is shifted in form of increase in price of commodities hence inflation.

- It encourages resentment to the government. People protest against high prices which makes the ruling government unpopular.

- It encourages corruption and fraud which reduces its efficiency. Corruption is encouraged between tax assessors and tax payers by undervaluing goods so that they pay little amount tax.

- It is complicated to understand by tax payers and collectors thus calls for continuous tax education which increases costs of its collection.

- It requires proper and systematic record keeping by suppliers and government machinery which is not common hence less revenue is realized.

- It leads to reduction in consumption of goods. The tax leads to increase in prices of goods hence a reduction in consumption and consumer welfare.

Concepts used in value added tax

1. **Zero-rated goods or supplies;** are those on which a tax payer is given complete relief on value added tax both on inputs and output e.g. supply of educational materials and printing services for educational materials, supply of agricultural output etc.

2. **Exempt goods or supplies;** are those goods on which the trader does not charge consumers any value added tax and cannot claim back any VAT already paid on inputs. E.g. assuming that Arkright project sells a house, it cannot charge VAT on the house and at the same time cannot reclaim VAT that was paid on inputs like nails, iron sheets, plumbing materials etc. during the process of constructing a house.

3. **Standard rate goods;** are those goods or business transactions that do not fall under exempt and zero-rated categories and therefore liable to VAT payment e.g. soda, textile materials, sugar, salt, electric appliances, motor spare parts, motor vehicles etc.

4. **Taxable supplies;** are supplies of goods which are liable to value added tax at standard rate or zero rate.

5. **Taxable person;** is an individual who is liable to value added tax or anyone carrying out business with a taxable turnover.

6. **VAT payable;** is the net value added tax to be paid to the tax authorities by the taxable person.

7. **Input tax;** refers to a tax in form of value added tax paid on purchases of inputs by producers. It is paid in advance whenever an item is purchased.

8. **Output tax;** refers a tax in form of value added tax paid on sales. It is usually paid after the sale of any item at that particular stage of production.

9. **Tax invoice;** is a document which shows specific details of a transaction required to support a claim or refund of an input tax. It is more necessary for zero-rated goods. The invoice shows the description of goods, their values, VAT charged on them and total value of goods to be supplied.

Merits of indirect taxes:

- **They protect domestic firms/ industries**. This is through imposition of high tariffs on imported commodities hence making them more expensive than locally produced goods.
- **They promote effort of the citizens/people in the economy**. This is so because people work hard to earn more income and thus catch up with the rising cost of living.
- **They discourage production and consumption of demerit/harmful goods.** This is because imposition of high indirect taxes on such products makes them less affordable to people who eventually abandon them.
- **They influence proper allocation of resources/ influence investment.** Government levies high indirect taxes on non-priority activities and extends tax incentives on priority areas hence influencing the level of investment in the priority areas.
- **They improve balance of payments position**. Indirect taxes correct the balance of payment deficit of an economy by levying high import duty that discourages expenditure on them therefore reducing the volume imports and outflow of foreign exchange.
- **They help the government to acquire public revenue**. Indirect taxes provide a reliable source of revenue for government because they are comprehensive in nature, having a wide range tax base.

Demerits of indirect taxes:

- **They undermine the volume and benefits of trade**. This deprives the economy of the benefits from trade, because the demand for goods and services on which the taxes are levied tends to fall because the market prices rise due to the imposition of indirect taxes on the goods.

- **They tend to be regressive in nature and thus promote inequality.** This is because of a uniform rate to all groups of income earners such that the poor suffer a bigger tax burden because a bigger proportion of their income is paid in tax while the rich incur a smaller tax burden because only a small percentage of their income is paid in tax.

- **They reduce consumer welfare**. This is due to reduced consumption of essential commodities that are highly taxed.

- **They promote trade malpractices such as smuggling**. This is because traders find it difficult to pay the high taxes and instead engage in illegal trade activities as a way of evading taxes, which denies government tax revenue.

- **They tend to be inflationary /lead to cost-push inflation**. This is because of the tendency of the producers and sellers to raise the market prices of the goods on which the taxes are imposed in order to cover the tax levied.

- **They lead to resentment of government/lead to traders' unrest**. This is because of increase in costs of which reduces the profit levels of the producers.

- **They discourage investment**. This is because they tend to reduce the level of effective demand for goods and services in the economy due to high prices of goods; these lower the profit levels and thus discourage investment.

- **They lead to misallocation of resources.** People divert resources from highly taxed economic activities to non-productive ventures or non-taxed commodities which may not be very beneficial to the ordinary citizens.

- **They breed inefficiency in the protected firms**. The protected firms tend to remain infant; this is because the protected firms are shielded from competition which makes them inefficient.

- **They lead to increased cost of production**. This is due to the high cost of factor inputs such as fuel which makes production very expensive.

Reasons for preference of indirect taxes to direct taxes:

- Indirect taxes are more comprehensive **than** direct taxes hence a more reliable source of revenue to the government.
- Indirect taxes are more convenient **than** direct taxes since they are only paid when spending occurs, yet direct taxes are imposed directly on the income and property of individuals and they are in lump sum.
- Indirect taxes are less felt and resented since they are imposed on goods and services **unlike** direct taxes which are imposed on income and property of individuals and enterprises.
- Indirect taxes are difficult to evade and avoid as they are hidden in the prices of goods and services **yet** direct taxes are easy to evade and avoid because they are levied on incomes and property.
- Indirect taxes are more impartial/ neutral to the tax payers since all people pay for them when buying goods and services **yet** direct taxes exempt certain groups of people e.g. students, the unemployed, the elderly e.t.c.
- Indirect taxes are economical in terms of collection since they are paid by the producers **yet** direct taxes involve a lot of costs by the tax officials to trace the different sources of income.
- Indirect taxes are more flexible/elastic and therefore can easily be changed with changing economic conditions hence enabling the government to raise more revenue **unlike** the direct taxes that are not revised regularly.
- Indirect taxes are more useful on checking consumption of harmful/ demerit goods **than** direct taxes since heavy indirect taxes are imposed demerit goods making them less affordable to the consumers thus forcing them to abandon them.
- Indirect taxes are relevant in protecting infant industries by using import duties which make them more expensive than locally made goods **unlike** direct taxes which are imposed on only incomes and property of individuals.
- Indirect taxes are not a disincentive to hard work and initiative since they are transferred to the tax payers in form of high prices **yet** most direct are progressive in nature hence discourage those who work hard to higher income and wealth.

CONCEPTS USED IN TAXATION

1. **Taxable income.** This is the amount of income which is subject to taxation.

2. **Taxable capacity.** This is the ability of the tax payer to pay the tax assessed on him/her and retain enough disposable income to enable him/her lead a life he/she is accustomed to.
   Or: The ability of a nation to raise expected revenue from taxes without causing socially harmful results or effects.

Or: the extent to which government can levy taxes without causing adverse effects on the tax payers.

Taxable capacity of a nation is influenced by the following:

- Political climate
- Level of economic development of a country
- The rate of inflation
- Level of accountability among revenue officers
- Level of tax evasion and tax avoidance
- The popularity of government
- Level of dependence burden
- The level of income/wealth distribution
- The size of gross domestic product
- Level of effectiveness of methods of tax collection used.

3. **Taxable base: This** refers to an economic unit or activity (income, person, firm, institution, property) on which tax is levied.

Reasons for narrow taxable base in Uganda include:

- Existence of a large subsistence sector/limited commercialisation of the economy.
- Low levels of income
- Under developed infrastructure.
- Limited employment opportunities.
- Tax exemptions/provision of tax incentives to potential tax payers by the government.
- Poor identification of tax sources/ Limited skills of tax officials
- Limited economic diversification/low levels of investment/ low levels of industrialisation.
- Political instability making it difficult to access possible tax sources.
- Low level of accountability/ corruption.
- Large informal sector/small formal sector.

4. **Tax avoidance.** This refers to the tax payer's exploitation of the loopholes in the tax law in order to pay little or no tax at all**. (It is legal)**

5. **Tax evasion.** This refers to the deliberate refusal of the tax payer to pay tax assessed/ imposed on him.(**it is illegal**)

Reasons for tax evasion include:

- Unfair tax assessment by tax authorities
- Lack of adequate information by tax payers about taxes
- Discontent about provision of services by the government
- Low income levels of tax payers
- Poor tax administration hence failure to effectively enforce tax compliance.
- Desire to retain all profits or earnings by business people.
- Political sabotage especially from opposition group.

6. **Tax revenue** is the money raised by the government through imposition of taxes.

7. **Tax holiday or concession** refers to a specific period of time given to a tax payer during which he is not supposed to pay tax. It is aimed at enabling a firm to cover initial costs of production.

8. **Tax exemption** is the act of fleeing a tax payer from paying tax. Tax exemption can be made on commodities either produced locally or imported from outside the country.

9. **Tax rebate** refers to a refund of a tax made under specific circumstances e.g. when government is in need of promoting industrialisation.

10. **Tax haven** refers to a country which imposes low rates of personal and corporation taxes. The aim is to attract rich investors and multi-national corporations which seek to minimize tax liabilities.

11**. Tax return** refers to a form which must be completed by all tax payers for the Inland Revenue. The tax payers give details of their income, capital gains, and allowances.

12. **Pay as you earn** is a scheme for collecting income tax due from individual's earnings. It is done by deducting that amount before the individual is paid his wage or salary.

13**. Tax threshold** refers to the income level at which a person becomes liable to income tax after all his allowances have been calculated e.g. Ug Shs 235,000 is the threshold for PAYE in Uganda.

14. **Marginal rate.** This refers to an additional tax paid as a result of extra unit of income earned.

15. **Specific tax** is one levied as a specific sum of money for a physical unit of a good.

16. **Impact of a tax:** This refers to the person or firm on whom a tax is initially officially levied.
Or: It is **the first resting place** of a tax when it is imposed.
Or: the immediate effect of a tax on a person on whom it is levied.

17. **Tax liability** refers to the total amount of money a tax payer is supposed to pay to tax authority in a given period of time.

18**. Consumption tax (outlay)** is a levy or charge on consumption expenditure of an individual consumption unit.

19**. Deadweight tax** is a tax once imposed makes the tax payer abandon the economic activity which forms the tax base on which tax is levied.

20**. Withholding tax** is tax paid to the customs authority until import duties have been assessed and paid. In some cases, a tax refund is made to a trader if withholding tax paid is more than the tax assessed.

21. **Tax yield** is the total amount of revenue generated from taxes when costs of collection have been deducted from original tax revenue.

22. **Tax burden** is the effect of a tax on tax payers' welfare in form of sacrifice of goods and services, and loss of money.

23. **Tax incentives** refer to inducements designed by tax authority to promote investment or business activity in an economy for instance tax holidays, tax exemptions, tax rebates etc.

24. **Tax allowance** refers to relief made to a tax payer on which he doesn't have to pay tax e.g. tax free allowance for children, wives which are deducted from personal income before tax is calculated.

OR: it is the percentage of one's income which is not taxed.

25. **Tax structure** is the composition of tax according to either mode of payment (direct and indirect) or percentage of income paid as tax i.e. progressive, proportional etc.

26. **Rate of tax** is the tax expressed as a percentage of the base on which it is imposed.

27. **Average rate** of tax is the percentage tax one pays from his income for instance 20% of Shs.50, 000.

THE INCIDENCE OF TAXATION:

This refers to **final resting** place of a tax.
OR: The person who ultimately bears the money burden of tax. For example, in case of personal income tax, it is mainly the tax payer to bear the burden of a tax.

The incidence of a tax mainly depends upon the price elasticity of demand and supply of a product. For the case of producers or suppliers, the burden is great when the demand for the product is elastic, and where the demand is inelastic, the burden is more on the consumers of the product.

Tax shifting: This refers to the process of transferring the tax from one individual/entity to another person/tax payer.

Tax shifting may either be forward/backward

Forward shifting of tax: This refers to the situation where the burden of paying a tax is transferred to the final consumers in form of increased prices for goods and service .

Backward shifting of a tax: This is where the burden of paying a tax is transferred to suppliers of the factors of production especially labour in form of reducing payments to such factors of production .

Problems faced by tax authorities in developing countries

- **High level of tax evasion**. Many tax payers out rightly dodge tax payment and this limits tax revenue realised by the government.
- **Limited skilled tax administrators/ Limited skilled manpower.** Most tax officials are not properly trained on how to collect revenue without using brutal means. This makes tax payers to hate tax payments.
- **Low taxable capacity**. Many people have extremely low level of incomes that cannot be subjected to taxation while others due to their low level of incomes cannot pay taxes at all, this leads to low tax revenue collected.
- **Poor infrastructure**. Economic infrastructures in some parts of developing countries are very poor such as roads thereby limiting accessibility to tax sources hence low revenue collected.
- **Corruption/low levels of accountability among officials of the tax authorities**. This leads to high loss of revenue through poor assessment and misappropriation of funds hence limited revenue.
- **Political instability in some parts of the country**. Political instabilities scare tax collectors from collecting taxes and assessors due to fear of losing their lives which leads to low revenue.
- **Narrow tax base.** There are limited entities that are subject to taxation due to limited diversification of economic activities. Also the tax system isn't comprehensive to generate more revenue.
- **Difficulty in identifying taxable sources or limited information about peoples' earnings**. This is due to the fact that people do not want to reveal information concerning economic activities they engage in for fear of high taxation.

- **Frequent changes in employment, contracts, and areas of residence**. These make work of tax assessors and tax collectors complicated hence less revenue is realised.
- **High level of tax avoidance**. The tax payers use a variety of loopholes in the tax law to avoid tax payment. This is done by substituting taxed activities by non-taxed ones or by declaring imported manufactured goods as intermediate products to be used in the production process thereby avoiding payment of taxes.
- **Political interference in the operations of tax authorities in the country**.
- **Conflicting government objectives/policies.** The government wants more tax revenue collected but at the same time exempts some individuals/entities
- **Resistance from the public against tax payment.** Potential tax payer organise demonstrations against certain taxes which intimidate the tax authorities and thus reduce the tax rates or abandon some taxes which limit government revenue.

Measures to improve tax collection and administration in an economy

- **Ensure political stability**. This will attract more investments hence widen the tax base and at the same it will easy for the tax authorities for proper tax assessment and collection and thus increase tax revenue.
- **Improve economic infrastructure**. This will help to promote production and increase the taxable capacity in the country which leads to increased tax revenue.
- **Commercialise the economy**. This will help to reduce dependence on subsistence sector so as to improve on the level of economic activities which will widen the taxable base due increased incomes of the people
- **Reduce the level of unemployment**. This will enable people have access to income, and this will increase their taxable capacity, thus enable the government increase tax revenue.
- **Review already existing tax laws**. This will make it simpler to administer the tax system and thus improve tax compliance.
- **Expand the industrial sector**. This will increase the volume of value-added output, and thus widen taxable base and revenue to the government.
- **Diversify taxes**. This will lead to introduction of different types of taxes such as rental income tax, pay as you earn etc. which will widen taxable base and increase government revenue.
- **Undertake capacity building of human resource or manpower training.** This is aimed at enhancing professional skills, competence and efficiency in tax administration and collection hence generating more revenue.
- **Liberalise the economy**. This is aimed at allowing people to engage in different economic activities, increase output of goods and services hence increase taxable capacity, tax base and thus more revenue generated.
- **Undertake further privatisation of public enterprises**. This is aimed at promoting efficiency, increased output and taxable base hence increased tax revenue to the government.
- **Improve taxpaying culture among citizens or sensitise the masses on benefits of taxation**. This is aimed at increasing tax compliance and the level of awareness through tax education programmes such as seminars, workshops.
- **Fight corruption/ Ensure proper accountability**. This can be achieved through channeling payment of taxes in banks, punishing those tax officials found guilty of embezzling funds and eventually this will increase tax compliance.

- **Adopt anti-smuggling measures**. Tax monitoring units should be introduced to check all malpractices in taxation e.g. special revenue protection unit by Uganda revenue authority.

- **Encourage proper and effective use of taxes**. This is achieved through proper budgeting for funds and accountability showing benefits from tax revenue to the community hence enhancing compliance to tax payment and thus reduce tax evasion.

Factors that influence the size of tax revenue in an economy

- The size of taxable base or the number of taxable entities.
- The cost of tax collection
- Level of tax avoidance
- Level of tax evasion
- Level of infrastructural development
- Degree of accountability by tax officials
- Level of taxable capacity
- Availability of information/data for tax assessment
- Level of monetisation of the economy or size of the subsistence sector.
- Level of skills of tax administrators
- The size of formal or informal sector/level of record keeping by business people.

THE STRUCTURE OF TAXATION IN UGANDA

Structure of taxation refers to the composition of a tax system according to either the mode of payment (direct and indirect taxes) or the percentage of income paid as tax (progressive, proportional and regressive)

Tax structure looks at the following aspects;

- Forms of taxes levied.
- Relative importance of each tax.
- Taxable capacity
- The fraction of GDP taxed (tax-income ratio)
- Objectives of taxation.
- Tax avoidance and tax evasion.
- The impact of taxation e.g. on the rich and the poor.
- Overall contribution.
- Problems of taxation.
- Institution which collect taxes.

Below are the major components of the structure of taxation in Uganda.

1. **Tax administration:** The body responsible for tax assessment is Uganda Revenue Authority. It assesses and collects all taxes in Uganda on behalf of the Ministry of Finance (Central government). The other taxation authorities are the local government authorities/district administration/municipal councils
2. **Forms of taxes levied:** These are numbers of direct taxes imposed on peoples incomes and accumulated wealth such taxes include, pay as you earn, income tax etc. the direct taxes are progressive and these tend to discourage the tax effort to their increase their effort since lose a proportion of their extra incomes earned. The corporation taxes are also a disincentive to investors. A number of indirect taxes are also imposed such indirect taxes include VAT, customs duty etc. most of the tax revenue is obtained from these indirect taxes.

3. Objectives of taxation. The main objective of taxation in Uganda is to raise revenue for recurrent and development expenditures the other objective is to redistribute income and wealth so as to reduce income inequality. Uganda's tax base is narrow i.e. Taxes are levied on some incomes while much of the wealth is not taxed. Foreign trade is the most taxed activity therefore the tax system is not comprehensive enough because not all wealth, incomes and expenditure are taxed.

4. Taxable capacity. The taxable capacity in Uganda is low because of the large subsistence sector and the general poverty/low levels of income of people in the country.
5. Tax gross domestic product ratio (GDP ratio). The proportion of the GDP which contributes to the tax revenue is less than 20% and this is mainly due to low taxable capacity and a narrow tax base.

6. Taxation impact: Most taxes especially indirect taxes are regressive in nature. The commodity taxes tend to affect the poor more than the rich, the very rich pay lower % of their income, wealth as tax as compared to the poor.

7. Tax avoidance and tax evasion. The rate of tax evasion is high especially through defaulting and capitalisation of the tax. Tax avoidance is low since most indirect taxes are levied on essential commodities.

IMPLICATIONS OF A TAX STRUCTURE IN UGANDA:

- Less revenue is collected as a result of low taxable capacity.
- It reduces the level of economic growth by discouraging production thus leading to low output.
- Too much emphasis is put on regressive indirect taxes which widens the problem of income inequality in a country.
- It leads to too much borrowing to finance the national budget due to less tax revenue collected.
- The strong desire for revenue leads to high levels of taxation on people's incomes which reduces their disposable income thus leading to low aggregate demand.
- Indirect taxes are inflationary in nature as they lead to increase in the cost of production thus forcing the producers to shift such increased costs to the consumers inform of increased prices for goods and services.
- It worsens the unemployment problem as investments are discouraged due to high tax rates on commodities.
- It leads to low tax revenue collection which results into budgetary deficits.
- The heavy borrowing to supplement the low tax revenue worsens the BOP deficit through debt financing.
- The multiple tax authorities sometimes lead to double taxation on some tax bases.

SUBSIDIES:

A subsidy is the amount of money granted by the government to producers of essential commodities. It is intended for the following purposes.

- To reduce the production costs in order to increase output.
- To increase production and supply of a given commodity.
- To low/to reduce the price of the commodity to the consumers in order to improve their standards of living.
- To increase the demanded and supply of essential commodities.

PUBLIC DEBT AND THE BUDGET:

PUBLIC DEBT: This refers to a debt incurred by the **central government**, **local governments and public corporations** as a result of borrowing from within the country or from external sources.

OR: A Public debt is the total borrowing by the **state, local authorities** and **public corporations.**

Public dent is a major source of government revenue that supplements its expenditure.

NATIONAL DEBT: This is the money owed by the state/central government to people and institutions within its borders or to foreigners, excluding the debts of local authorities and public corporations

A public debt can be contracted either internally or externally as a source of government revenue to supplement its expenditure.

Internal/ domestic debt. This is the money borrowed or owed by the government from its people and institutions (domestic entities) with in the country. The government can borrow from rich individuals, private financial institutions and companies. It can also borrow by selling securities like bonds and bills to the public

External debt. This is the money borrowed/ owed by the government to foreign governments and international agencies/ from outside sources. e.g. IMF, World Bank. Most developing countries get revenue for development by borrowing externally.

Some terms used in public debt:

Debt contraction. This refers to obtaining of a loan or a debt from a lender. It is usually so formal in getting external debt because the lender and borrower must both sign the debt agreement after agreeing on terms and conditions therein stated

Years of grace (grace period). This is a period between debt contraction and the time when debt servicing begins.

Debt servicing. This is payment of interest on the loan contracted with or without part of the principal. It begins after the years of grace.

Debt retirement. This is the payment the final installment of the loan contracted to the lender/ creditor. It takes place after debt servicing.

Concessional bilateral debts These are debts from countries for which a very low rate of interest is paid and repayment of the principle takes a long period say 20 years and more.

Non- concessional debts. These are loans that are given by either government or international financial institutions such as IMF basically on commercial terms. Lenders of such loans are purely business driven and therefore these loans carry high interest rates

Interest free loan. This is a loan given to a country with no interest expected on the principle.

Bad debt: This is a debt which is costly, difficult and impossible to be repaid.

Hard loan. This is a financial advance/ loan with high interest rate yet with very short repayment periods. It is mainly paid in currency of a nation that has economic stability and a sound reputation abroad

Soft loan/ self-financing loan. This is a financial advance/ loan with below market or very low or no interest and yet provides other concessions to borrowers such as long repayment periods, interest holidays, extended grace period.

CLASSIFICATION OF A PUBLIC DEBT:

1. **Classification according to how the debt is used/ the purpose/productivity**

(a) **Reproductive debt/Productive/ self liquidating debt:** This is one incurred to finance productive activities which generate income/revenue, part of which can be used to repay a debt, such a debt **is self liquidating** (finances itself) e.g. borrowing to build a factory, power dam, construction of infrastructure.

OR: It is a debt which is used finance projects that bring in returns. e.g. used to purchase industrial inputs/real assets i.e. a self-liquidating debt.

OR: It is one where the borrowed money is used to purchase real assets/ finance **productive projects** which bring in returns used to pay back the loan i.e., it is **a self – liquidating debt.**

(b) **Dead weight debt/ Unproductive debt:** This is one incurred to finance unproductive activities/for consumption e.g. borrowing to finance a war, to finance the salaries of civil servants, borrowing to provide relief service

OR: It is one where the borrowed money is used to finance unproductive projects i.e.**it is not self-liquidating** E.g. buying firearms, i.e. not a self liquidating debt.

2. **Classification of debts according to the method of debt repayment/ management.**

(a)Funded debt: This is a **long term debt** for which the there is no redemption date/date of repayment but the borrower keeps paying annual interest on the principle.

(b) Unfunded debt/ Floating debt: This is a **short term** debt whose repayment date is definite/known.

REASONS FOR INCURRING PUBLIC DEBTS/THE NEED FOR PUBLIC DEBTS

Government borrows internally and externally because of the following reasons.

To ease the burden of taxation on citizens in the short run. With increased borrowing, the government doesn’t have to levy heavy taxes from the nationals.

To raise funds currently needed for recurrent public expenditure. This is because the other sources of revenue are limited and the revenue needed for public expenditure not enough and thus the government resorts to borrowing to cover the revenue expenditure gap.

To finance the balance of payment deficit in the short run. The money borrowed comes in form of foreign exchange which increases its supply in the economy.

To supplement tax revenue. This is because borrowing provides an opportunity to the government to mobile external resources which adds tax revenue and hence enabling the government to meet her expenditure.

To control inflation by reducing amount of money in the hands of the public. Internal borrowing reduces the amount of money in the hands of the people; this reduces the consumers’ purchasing power by reducing aggregate demand thus controlling demand pull inflation.

To fill the saving investment gap/ development/capital expenditure gap. The local savings in developing countries are very minimal and the alternative is to borrow and finance investments.

To sustain market by leaving citizens with adequate disposable income. Borrowing makes the government to tax less the citizens which leaves them with sufficient disposable income that is used to purchase different goods produced in the country.

To help the country borrowing achieve and maintain a given level of employment. This is because borrowing enhances investment and thus leading to creation of more jobs.

To handle the effects of disasters/calamities. Disasters such as earthquakes, floods, famine and landslides force the government to obtain debts so as to provide relevant necessities/relief to the victims/the affected communities.

To help repay interest and even the principle sum borrowed. Increasing pressure on debt servicing normally forces the country to borrow especially from cheaper sources to offset an expensive debt/loan.

Advantages/Merits/ positive effect of Public debts/ Public borrowing:

- It eases the burden of taxation on the citizens/ reduces the negative effects of work effort and consumption.
- It fills the manpower gap/increases labour skills
- It raises funds currently needed for public expenditure
- It fills the foreign exchange gap/finances the balance of payment deficits in the short run.
- It supplements tax revenue/ Fills the government revenue expenditure gap
- It controls inflation through internal borrowing.
- It fills the saving investment gap/ Raises funds for investment.
- It increases employment opportunities
- It alleviates effects on natural calamities.
- It helps to settle debts.
- Narrows the technological gap/ Facilitates importation of modern technology
- Helps to fight demand pull inflation i.e. the case with internal borrowing.
- Sustains markets by leaving consumers with adequate disposable incomes.
- Promotes industrial development
- Increases utilisation of idle resources
- Leads to economic growth
- Leads to infrastructural development
- Improves the relationship/friendship between the recipient country and the donor country.

Disadvantages of public borrowing:

- **It worsens the balance of payment position/deficit**. This is so because it increases the outflow of foreign currency through debt servicing and repayment of principle sum borrowed.
- **It is inflationary i.e. a case with external borrowing**. This is mainly because external borrowing increases inflow of money in the economy and this leads excessive aggregate demand over supply, consequently resulting into demand pull inflation
- **Nationals are denied essential goods due to debt repayment**. Debt repayment requires government to reduce her expenditure on provision of essential goods such as merit and public goods so because a lot of money is spent on debt servicing and repayment.
- **It leads to misallocation of resources/ encourages extravagance/ corruption**.
- **Leads to manipulation of the country by foreigners**. External borrowing encourages foreign dominancy where the donors influence decisions to the country both political and socially.

- **Shifts the burden of debt repayment to the future generation who may not have benefited from the debt but pay it**. The future generation is forced to pay back the debts they didn't incur or the money that they didn't benefit from.
- **Undermines private investment due to public borrowing outcompeting private investment in both the money and capital markets.**
- **External debt payment limits import capacity.** This is because it reduces the amount of foreign exchange in the country since a lot of it is used for debt servicing and repayment of the principle sum borrowed
- **Citizens are burdened by taxes to raise revenue for debt repayment**. The government increases taxes on the citizens in order to accumulate funds for debt servicing and debt repayment of the principle sum borrowed.
- **It encourages/ laziness.** Public borrowing makes people to get used to free things which make them reluctant to work hard since they are assured of survival from the transfer payment.
- **Undermines capital formation due to debt repayment.** A lot of funds are used for debt servicing and payment of the principle sum of money borrowed, this reduces the amount of funds that would have been used for capital formation.

PUBLIC DEBT MANAGEMENT

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

Note: Debt servicing refers to the payment of interest and sometimes part of the loan acquired.

Objectives of public debt management

- To maintain price stability
- To influence income distribution/control income inequality
- To influence the rate of interest.
- To ensure proper utilisation of funds/minimise or control corruption
- To reduce the debt burden/ minimise the cost of public debt
- To mobilise financial resources.

Debt redemption/repayment: This refers to the various ways through which a country clears its debt acquired both from internal and external services.

WAYS OF CLEARING/ REDEEMING A PUBLIC DEBT:

- **Through negotiating for debt relief/ debt cancellation:** Government can negotiate for the cancellation of a debt with donor country and consequently, the donor country may write it off. The negotiation may be based on economic hardships a country may be facing .e.g. in 1990 Uganda had debts with IMF and the World Bank and they were cancelled under the highly indebted poor country initiative
- **Through debt rescheduling:** This involves asking for an extension in the time/ date of repayment
- **Through conversion:** This involves borrowing from a cheaper source to pay a due date.
- **Through drawing on foreign exchange reserves/ Use of foreign exchange reserves.** The country's foreign exchange reserves in the central bank can be used to pay off the debts.
- **Sale of gold reserves.** The money realised/obtained from the sale of gold reserves can be used to clear a public debt and this reduces debt burden.

- **Through sale public investment/ disinvestment/Privatisation:** This involves selling parastatal bodies and public corporations so to raise funds necessary to clear the debts.
- **By soliciting for grants and donations/ gifts.** This can be got from friendly countries especially the developed countries and this can be used for paying off the debts.
- **Through sale of government securities to the public.** The government through the central bank issues and sales treasury bills and bonds which enables her to borrow internally
- **Through creating a sinking fund.** This involves putting aside some money by the government in the budget for future debt redemption/repayment.
- **Through debt repudiation.** This involves the deliberate/complete refusal by a country to pay its debts.
- **Drawing a surplus.** The government can use its surplus budget in a given financial year to pay off the internal debts.
- **Through borrowing from the central bank/printing more money/financial accommodation.** The government can obtain short term loans from the central bank to clear loans and this usually involves printing money

DEBT FINANCING VERSUS TAXATION FINANCING

Debt financing: This is where the government borrows money to finance its expenditure that may not be covered by the tax revenue.

Taxation financing: This is where the government uses revenue from taxes to finance its expenditure.

It involves raising taxes as the main source of revenue and at the same time there is limited borrowing.

Advantages of debt financing over taxation financing

- Borrowing/debt financing doesn't have negative political effects **compared** to taxes that may cost the government's political popularity.
- Debt financing helps to realise a lump sum of money **compared** to taxation which is slow in bringing money. i.e. borrowing is a quicker way of raising money.
- It is easier to borrow money **than** tax individuals. This is because of the narrow tax base.
- Debt financing makes use of both local and foreign sources of revenue **compared** to taxation which is only internal.
- Debt financing does not have adverse/negative effects on the consumption **compared** to taxation that reduces disposable income of the people.
- Debt financing does involve the methods of collection **compared** to taxation.
- Debt financing does not involve discourage production by increasing cost of production **unlike** taxation which increases cost of production.
- Debt financing does not discourage savings and investment **compared** to taxation.
- Debt financing increases foreign exchange reserves of the country and encourage foreign investment **compared** to taxation which discourages foreign investment.
- The burden of borrowing can be postponed to the future generations **than** taxation whose burden is felt by the present generation.
- Borrowing can be used to fight inflation, especially internal borrowing **compared** to taxation which causes cost push inflation.
- Borrowing is a quicker method of raising money **than** taxation.

Advantages of taxation financing:

- It minimises economic dependence because of reduced borrowing.
- Taxation financing encourages hard work as people put in more efforts to pay the taxes imposed on them.

- It improves on the balance of payment position of a country. This is because of limited borrowing which reduces expenditure of foreign exchange on debt servicing.
- It minimises inflation. This is because the high taxes imposed by government reduce the disposable incomes of people.
- It encourages the use of internal resources because most of the external resources are stopped from coming into the country.

Disadvantages of taxation financing:

- It discourages savings and investment. This is because high taxes leave people with very little income to save/invest.
- It increases the cost of production. This is common with high indirect taxes which lead to cost push inflation.
- High taxes have negative impacts on consumption. This is because they reduce peoples disposable income hence reducing their welfare.
- There is limited revenue realised from taxes because of the narrow tax base.
- It denies a country to have access to external resources because it relies mainly on taxes at home.
- It is not easy to raise money through taxes because the money comes in bits since people do not pay taxes at the same time.
- It makes the government unpopular. This because people are against paying taxes.

Debt burden: This is the real cost of borrowing on the present and future generation of a country.

Expression of debt burden

Public debt burden is expressed or measured as a percentage of different variables in the economy. These percentages can be expressed on the internal debt and/ or external debt.

Internal debt burden

- **Debt as a percentage of GNP.** This shows the proportion or percentage of the country's GNP/ output which is for loan/debt repayment. A higher percentage reflects a bigger debt burden and vice versa.

  Debt burden $= \frac{Total\ debt}{GNP} \times 100$
- **Debt as a percentage of labour employed.** This shows the proportion of the debt per labour employed i.e. it shows the percentage of the working population which is directly affected by debt repayment.

  Debt burden $= \frac{Total\ debt}{Total\ Labour\ employed} \times 100$
- **Debt as a percentage of the population.** Expresses/ shows the amount of the debt paid per person.

  Debt burden $=\frac{total\ debt}{Total\ population} \times 100$

- **Debt as a percentage of government revenue from tax payers.** This shows the proportion of government revenue committed to debt payment.

  Debt burden $= \frac{Total\ debt}{Total\ government\ revenue} \times 100$

- **Debt expressed in terms of amount paid to cover the debt per tax payer** i.e. the debt per tax payer. A large percentage implies a higher tax burden.

  Debt burden $= \frac{Total\ debt}{Total\ number\ of\ tax\ payers} \times 100$

External debt burden

- **Debt as a percentage of foreign exchange earnings from export.** This shows the amount of exports required to pay the debt.

  Debt burden $= \frac{Total\ debt}{Total\ foreign\ exchange\ earnings} \times 100$
- **Debt as a percentage of imports.** This shows the amount of imports reduced to pay the debt.

  Debt burden $= \frac{Total\ Debt}{Imports} \times\ 100$
- **The rate of interest on borrowed funds.** The public debt can also be expressed in terms of interest rates payable **on borrowed funds.** i.e. soft loan or hard loan. The higher the interest rate the higher the debt burden and vice versa.
- **It can also be expressed in terms of repayment period** i.e. long term or short term loans. The shorter repayment period, the higher the debt burden

THE NATIONAL BUDGET: This is a statement which shows the **estimated/anticipated planned** government revenue and **estimated/ anticipated/planned** government expenditure in a given financial year.

A national budget deals with policy techniques which must be followed in the forthcoming financial year.

A budget is categorised into two.

i) **Recurrent budget:** This refers to a statement which consists of the estimated government revenue aimed at financing the day today running of the state during a specified financial year i.e paying salaries of civil servants.

ii) **Development budget:** This is a statement that consists of the estimated government revenue aimed at financing long term and medium term projects e.g. road construction establishment of state industries etc.

Types of national budget:

i) Balanced National budget: This is one where government estimated revenue is equal to estimated government expenditure in a financial year.

ii) Unbalanced National Budget: This is one where government estimated revenue is not equal to government planned expenditure in a financial year.

Therefore, unbalanced budget may a surplus national budget or a deficit national budget.

i) Surplus National Budget: This is one where the government estimated/Projected/planned expenditure is less than the government expected/planned/projected revenue in a given financial year.

Reasons for planning a surplus budget:

- To reduce the level of aggregate demand so as to fight the level of inflation through increased taxation and reduction in government expenditure.

- To accumulate reserves for future investment.
- To enable government to advance and grants to other countries especially from developed to developing countries.
- To help government improve infrastructure/finance development projects that requires a lot of money.

Implications of a surplus national budget:

- It imposes heavy tax burden on the people which leads to adverse effects
- It reduces government expenditure which may decrease the rate of economic growth.
- It leads to a reduction in the level of business activity hence causing a deflation.
- It may make the government unpopular since it encourages heavy taxation of people's income which reduces their disposable income and the standards of living.
- Results into unemployment due to reduced investment because of high taxes
- The surplus can be used to give grants and gifts to other needy countries

A deficit national budget: This is on where government estimated/projected/planned government expenditure is greater than the government estimated/projected/planned revenue in a given financial year.

Reasons for planning a deficit budget:

- To increase aggregate demand and stimulate production in the economy.
- To increase consumption by raising disposable incomes of the people through low taxes.
- To close a deflationary gap/slump/ recession.
- To encourage investment in the country through reduced taxation.
- To avoid negative effects associated with taxation
- To encourage investment.
- To win political support
- Borrowing may be quicker and cheaper in raising funds/ To solicit for foreign aid

Effects of a deficit budget:

- Tends to be inflationary. This is because of increased government expenditure.
- Leads to increased costs of production.
- Leads to increase in money supply in the economy.
- Necessitates borrowing with its negative effects.
- Leads to increase in aggregate demand, employment opportunities, etc.
- Worsens B.O.P problems .This is due to excessive external borrowing to finance a deficit budget.
- Government may be able to sell its assets to raise money for spending**.**
- Encourages external resource dependence. This is common when the expenditure is financed by external borrowing.
- Makes government planning difficult. The expected funds to finance a deficit budget may not come in time making planning difficult.

THE OBJECTIVES OF A NATIONAL BUDGET:

- **To attain and maintain price stability/ to control inflation**. the budget through taxation, can be used to control inflation and maintain price stability in that during periods of inflation, the budget through taxation, can be used to reduce disposable income by increasing direct taxes on peoples' income.

- **To create employment opportunities/ to reduce unemployment**. The budget creates employment opportunities through increasing government expenditure in public works and also through provision of subsidies to the potential investors which stimulate investment and thus generate more employment opportunities.
- **To improve the balance of payment position/ to correct balance of payment deficit.** The budget improves the balance of payment position by increasing tariffs on non-essential imports to reduce their inflow, waving taxes on exports to increase their volume and thus increase export earnings.
- **To reduce income inequality/to promote equitable income distribution.** The budget reduces income inequality by taxing the rich more heavily than the poor using progressive taxation, this helps in re distributing wealth in the country and thus minimising the adverse effects of income inequality
- **To protect domestic (infant) industries/firms.** The budget protects domestic industries through imposition of tariff and non-tariff barriers on substitute imports to make them less competitive at home than locally produced goods. Infant industries are also be subsidised to lower their cost of production thus making such commodities compete favorably with imported commodities. This allows such industries to grow and expand.
  - **To discourage consumption of harmful/ undesirable products.** The budget discourages consumption of demerit goods through taxing them heavily and making them less affordable to the consumers so as to protect the consumers' wealth and morals in case of phonographic materials.
  - **To raise revenue to the government**. The budget raises revenue for the government through introduction of various taxes on goods and services, borrowing etc.
  - **To influence resource allocation/ to influence investment levels.** The introduces high indirect taxes on non-priority activities and extends tax incentives on priority areas hence influencing the level of investment in the priority areas.
  - **To accelerate the rate of economic growth.** This is achieved whereby in the budget the government increases her expenditure for the provision of infrastructure e.g. roads, power facilities to reduce the cost of production at the same time the budget introduces concession/incentives such as giving tax holidays, subsidies all these attract investment and thus increase economic growth rate.
  - **To mobilise/ solicit foreign resources.** The government uses the national budget to appeal to appeal to the donors for assistance by showing the deficits in her expenditure.
  - **To mobilise the masses to participate in national development.** The budget mobilises the masses to participate in different economic activities by providing an enabling environment for example through construction of infrastructure which motivates the nationals to engage in different economic activities thus help to achieve economic growth and development.
  - **To reduce economic dependence.** The budget increases domestic sources of public revenue so as to reduce external borrowing and at the same time, the budget accelerates the level of economic growth so as to increase domestic output and reduce the dependence on imported goods and also widen the range of economic activities within the country so as to reduce on dependence on imported goods.
  - **To regulate government expenditure.** The budget regulates government expenditure by ensuring discipline by government officials in different departments since the budget calls for proper accountability of all the funds received.
  - **To reduce regional imbalance in development.** The budget ensures regional balance in development by ensuring even development of productive infrastructure and also providing incentives to investors to encourage them to invest in different parts of the country thus reducing imbalance in terms of development.

THE BENEFITS/MERITS OF MAKING A NATIONAL BUDGET TO A COUNTRY:

- Regulates government expenditure. This is because the government makes plans to reduce her expenditures on non-productive activities while increasing expenditures on productive and essential activities e.g. health care. Road construction etc.

- Helps in mobilisation of resources
- Enables the government to solicit for foreign aid
- Promotes regional balance in development
- Stimulates investment
- Accelerates the rate of economic growth
- Enables the government to raise revenue
- Discourages consumption and production of harmful products
- Reduces income inequality
- Corrects balance of payment deficits
- Protects infant industries
- Promotes price stability
- Helps in job creation-
- Reduces economic dependence
- Mobilises the masses to participate in national development.

CAUSES OF PERSISTENT BUDGET DEFICITS IN DEVELOPING COUNTRIES

- **Rising/high costs of infrastructural development.** Such costs for establishment of hospitals, schools, power dam projects require a lot of funds to be set up and maintain to cater for growing population, this causes heavy government expenditure for beyond revenue.
- **Frequency of natural disasters/ hazards that require heavy emergency funding, such** as earthquakes, floods, landslides which destroy property and lives. Therefore, a lot of relief funds are needed to support victims specially to cater for food, medical care and shelter leading to heavy government expenditure than revenue.
- **High levels of corruption/embezzlement of public funds/low levels of accountability.** Government swindle public funds while others over budget beyond the funds required to implement the government budget leading to increased planned expenditure hence deficit.
- **Heavy expenditure on defense due to political instability/ low revenue due to political instability.** Developing countries like Uganda face a number of political unrests which leads to heavy expenditure by the government on military hardware and a big army to fight rebels and riots hence leading to heavy expenditure beyond the revenue.
- **Limited non- tax sources of revenue/low revenue from non-tax sources.** The government has fewer areas to get revenue than taxation e.g. fines, market dues hence government finds it difficult to raise adequate revenue yet government expenditure continues to rise causing a deficit.
- **Heavy expenditure on civil servants and politicians/ High administrative expenditure on politicians and civil servants.** This is due large of the public service, establishment of new districts, frequent elections, large cabinet and large parliament leading to heavy expenditure to support administration, payment of wages and allowances yet sources remain low.
- **Persistent /heavy debt servicing and repayment of principle.** Developing countries borrow both internally and externally to meet both the recurrent and development expenditure. This call for heavy government repayment obligations and servicing debts yet some debts are not self liquidating.
- **Heavy expenditure on external commitments. e.g.** Contributions to international organisations such as COMESA, E.A.C, A.U, UN leading to heavy government expenditure in relation to planned revenue.
- **Over ambitious planning, i.**e. planning beyond means. Government engages in very many projects beyond what it can handle such as power generation, proving free education at all levels, recruiting many civil servants etc, such projects lead to heavy government expenditure.

- **Few taxes/ Narrow tax base.** Developing countries like Uganda have few economic activities on which taxes are levied, therefore receive low tax revenue yet government expenditure needs are ever rising leading to a deficit.
- **Weak tax administration and management.** Some tax officials have limited skills of collecting taxes and identifying tax sources where taxes are levied hence resulting into low tax revenue in relation to rising government expenditure. Needs causing a deficit.
- **Low taxable capacity.** Many people in developing countries have extremely low incomes, therefore are unable to pay taxes and remain with enough disposable income to enable them continue enjoying the same standard of living they are accustomed to hence making government realise less revenue to meet government expenditure needs causing a deficit.
- **Increasing government expenditure on programmes to create employment opportunities e.**g. **Youth fund, teachers' SACCOs, loans for science students.** All these programmes take a lot of government money in form of expenditure than what she receives in form of revenue hence a deficit.
- **High degree of tax avoidance and tax evasion due to reasons such as widespread poverty, discontent about services delivered by the government among others.** This leads to low tax revenue realised in relation to rising government expenditure.

MEASURES TO MINIMISE BUDGETARY DEFICITS IN LDCs.

- **Encourage cost sharing in the provision of services. i.e.** sharing of costs between government and beneficiaries of government services like education, medical care among others so that the burden of expenditure is shared between government and those using the services hence government being able to cut down expenditure thereby controlling budgetary deficit.
- **Ensure political stability.** This helps to reduce government expenditure on defence and also to helps to stimulate productive economic activities where taxes are levied leading to increase in government revenue.
- **Decentralisation of power/ government.** The central government should empower local authorities like districts, municipalities and town councils to devise different sources to up their areas instead of relying only on the central government for survival hence leading to reduction in government expenditure.
- **Undertake further privatisation of state enterprises.** Government should continue to transfer ownership of state enterprises to private individuals. This enables government to acquire more revenue necessary for meeting government expenditures and also reduce government expenditure on supporting those enterprises especially through subsidisation
- **Fight corruption in state departments.** This should be done through strengthening institutions to fight corruption. This helps to minimise embezzlement of state revenue and also reduce government expenditure through employing officials to fight corruption and even government officials who tend to over budget beyond the funds required for project implementation.
- **Increase on non-**tax sources of revenue other borrowing e.g. fund raising, fees charged services provide by the government, market dues, special assessment etc. This helps to increase government revenue thereby reducing budgetary deficits.
- **Restructure and rationalise foreign missions and other government commitments**. Government should reduce on unnecessary frequent foreign travels by government officials by government officials, withdrawal them from some of the international engagements especially those that are unproductive by merging, closing some embassies hence helping to reduce government expenditure on such international commitments thereby reducing budget deficits.
- **Control population growth rate**. This helps to reduce government expenditure on provision of social services such schools, hospitals etc. hence minimising budget deficits
- **Avoid deadweight debts/reduce acquisition of unproductive debts**. All efforts should be made to avoid acquiring such debts that do not help to generate more income for the government since such

debts lead to heavy expenditure by the government on servicing and repaying them yet they do not generate income for the state.

- **Public servants should be retrenched/ Reduce administrative costs**. This will help to reduce government expenditure on various like paying wages and other allowances
- **Undertake further liberalisation of the economy**. This will reduce government participation in doing business which reduces government expenditure, at the same time it encourages the setting up of economic activities in the private sector which widens the tax base.
- **Widen the tax bases especially through supporting diversification of the economy.** This will increase revenue from taxes.
- **Improve tax collection.** This reduces tax evasion and tax avoidance and this increases tax revenue.