TOPIC 11: PUBLIC FINANCE AND FISCAL POLICY

Definition

Public finance refers to a section of macroeconomics which concerned with state (public) revenue and state (public) expenditure.

It is concerned with the various sources of public revenue and the different areas where the state spends money in order to achieve major objectives of national development

Nature and scope of public finance.

By public finance we refer to the financial activities of a state or government or local authority for example municipal council or a town council. Under public finance we study state revenue and state expenditure

In summary; public finance is the branch of economic theory, which deals with public (state) revenue and state expenditure

The study or scope of public finance is divided into four categories namely

1. **Public revenue or income.**
   The main source of public revenue is taxes, fees, fines, special assessments and commercial revenues from public undertakings. Public income is concerned with the canons and principles of taxation, the various direct and indirect taxes and their impact and incidence, the effects of taxation, the problems of tax evasion and avoidance and the measures to sold these problems so as to raise public revenues

2. **State expenditure or public expenditure.**
   Public expenditure is the use to which public revenue is put by a public authority. Under this section we look at the classification of public expenditure, the reasons for increase in public expenditure, and the effects of public expenditure on production, employment, income distribution, stability and growth

3. **Public debt (borrowing)**
   Public debt is what a public authority owes. It is a result of borrowing done usually when planned revenue falls short of planned expenditure. Under public debt are studies reasons, methods, effects and reasons for changes in the volume and pattern of public expenditure

4. **Financial administration.**
   The aim of financial administration is to control processes and operations of public revenue, public expenditure and public debt. The scope of financial administration includes the collection, custody and disbursement of public money, the coordination of expenditure according to a well formulated plan, the management of public debt, and general control of the financial operations of the state

OBJECTIVES OF PUBLIC FINANCE

Objectives of public finance in developing economies like Uganda are;

- To improve the levels of investment. Public finance aims at the promotion and acceleration of the rate of investment in the private and public sectors of the economy. Investment is influenced through provision of tax incentives such as tax holidays and tax rebates to investors to encourage them to invest in the economy
- To reduce income inequality. Public finance through taxation of the rich more than the poor and subsidization of goods consumed by the poor aims at reducing inequalities in incomes
- To raise government revenue. Public finance is a means of raising revenue for the government through measures such as taxation, licences, fees, special assessment and borrowing, among other measures. The revenue raised is used for recurrent and capital investment

- To control inflation. Revenue raised from taxation and borrowing are used for specific development projects such as irrigation, mining, power generation and road construction to increase production and supply to control inflation
- To protect local industries against foreign competitors. Public finance is used to protect local industries against foreign competitors. Public finance is used to protect local industries from competition by foreign industries. This is done by imposition of heavy tariffs on imports to make imported products relatively more expensive than locally produced goods
- To influence level of economic growth. Public finance aims at increasing economic growth through measures such as tax incentives given to investors to increase investment and production
- To improve on the balance of payments position. Public finance is used to improve the balance of payments position of a country by discouraging imports and encouraging exports. Restrictions such as import duties are imposed on imports to reduce expenditure abroad thereby improving the balance of payments position

FUNCTIONS OF PUBLIC FINANCE
- Improving the levels of investment
- Reducing income inequality
- Raising government revenue
- Controlling inflation
- Protecting local industries against foreign competitors
- Influencing the level of economic growth
- Improving on the balance of payments position

ROLE OF PUBLIC FINANCE IN A DEVELOPING ECONOMY
- Influences investment levels. Public finance aims at the promotion and acceleration of the rate of investment in the private and public sectors of the economy. Investment is influenced through provision of tax incentives such tax holidays and tax rebates to investors to encourage them to invest in the economy
- Reduces disparities in the distribution of income. Public finance through taxation of the rich more than the poor and subsidization of goods consumed by the poor to reduce inequalities in incomes
- Means of acquiring revenue for current and development expenditure. Public finance is a means of raising revenue for government through measures such as taxation, licences, fees, special assessment and borrowing among other measures. The revenue raised is used for recurrent and capital investment
- Improves on the country's balance of payments position. It is used to improve the balance of payments position of a country by discouraging imports and encouraging exports. Restrictions such as import duties are imposed on imports to reduce expenditure abroad thereby improving the balance of payments position.
- Protects local industries and domestic producers. Public finance is used to protect local industries from competition by foreign industries. This is done by imposition of heavy tariffs on imports to make imported products relatively more expensive than locally produced goods
- Influences employment levels. Public finance is used to influence the level of employment by, for example, encouraging new investments by provision of incentives to investors. It is also used to create employment opportunities through massive public investment in public works and public enterprises to increase the number of public sector workers and reduce unemployment
- Facilitates economic growth. It increases economic growth through measures such as tax incentives given to investors to increase investment and production
- Controls consumption of undesirable products. Public finance through fiscal tools especially taxation are used to discourage undesirable consumption. Consumption of demerit goods is discouraged by

taxing them heavily to make them unaffordable to consumers. Their importation and production are also regulated through the use of licences to allow only afew people to participate in their supply

- Maintenance of price stability. Through its tools, public finance can be used to control inflationary tendencies, hence price stability. Government borrows from the public through sale of government securities and taxes on consumer incomes to reduce aggregate demand and control inflation
- Used to bring about balanced regional development in an economy. Public finance can be used to balance regional development through measures such as discretionary fiscal allocations where disadvantaged regions get larger development grants from the central government than advantaged regions; increased government investment activities in the disadvantaged regions; provision of cheap investment loans to the regions and delocalization policies in favour of the backward regions

What is the role of public finance in your country?

PUBLIC REVENUE

The term public revenue refers to the total income of the state

SOURCES OF GOVERNMENT OR PUBLIC REVENUE

The government has two major sources of revenue

(i) Through taxation

Taxation constitutes the main sources of raising government revenue these could be received through either direct or indirect taxation or both

A direct tax is that paid by someone who is supposed to bear it, it includes graduated tax, personal income tax (P.A.Y.E), gift tax, wealth tax, supernormal profit tax, death or estate duty among others

Indirect tax on the other hand, is an outlay or expenditure tax that is levied on goods and services. It includes sales tax, customs duty, and excise tax among others

(ii) Through non-tax sources

Sources of non-tax revenue to the state may include

- Rent on government property
- Surplus from gambling
- Forfeitures
- Fees
- Rates
- Surpluses or profits from public enterprises
- Printing of money by the government
- Fines
- Gifts and grants
- License
- Special assessments
- Loans
- Market dues
- Disinvestments

SOURCES OR INSTRUMENTS OF PUBLIC REVENUE IN UGANDA

Sources or instruments of public revenue in Uganda include

- Taxes. Taxes are compulsory contributions imposed by a public authority irrespective of the exact amount of service rendered to the tax payer in return
- Loans. Government borrows both locally and externally when it fails to bridge the gap between planned revenue and planned expenditure through other ways, especially taxation. Externally, government gets loans from other governments of multi-lateral assistance agencies such as World Bank and IMF, internally the government borrows by floating her securities to members of the public
- Grants, donations and gifts. Government receives grants, donations and gifts from individuals, societies and other government. Grants are outright transfer payments from one entity to another usually for development purposes or relief work. Donations are in form of money or items that are given to help a person or organization. Gifts on the other hand, are voluntary offers from one government to another in appreciation of good conduct or act
- Licenses. A license is a payment to government to obtain permission to undertake a regulated activity, for example, to run a shop, drive a car and keep a gun
- Fees. Fees are payments for direct or particular services or for privileges rendered by government or state to individuals or firms. Examples include court fee, registration fee of property or marriage, payment of a fee for a competitive examination etc
- Profits or proceeds from government enterprises. Government runs commercial enterprises and public utilities. The surplus obtained by selling their goods and services are commercial revenues to government which are used to finance government expenditure needs
- Rates. Rates are payments made on urban private property such as land and houses. They are charged to enable town council and municipal authorities provide services to the properties (ie *are payments for utilities*)
- Fines. Fines are penalties imposed on people for infringement or breaking of state laws. The fines are imposed on people by law enforcement authorities especially courts of judicature
- Forfeitures. Forfeitures are properties which individuals and firms give up (forfeit) to government or public authority due to failure to legally claim them within them prescribed by law. The properties are in form of seizures from criminals, smugglers and importers who fail to clear tariffs on goods. The goods become state property and are auctioned to raise revenue for the government
- Special assessment. A special assessment is a compulsory contribution charged in proportion to the special benefits derived to defray the cost of a specific improvement to property undertaken in public interest. When a public authority provides certain facilities like street lights, drainage, parks and roads in a particular area, the people benefit. At the same time rent and values of properties in the area also go up. In line of those benefits, the government may also levy a special assessment on property owners
- Disinvestment proceeds. Disinvestment is the sale of government properties both at home and abroad, for example, public enterprises. The revenue raised is used to meet government recurrent and public expenditure needs
- Dues for example market dues. Market dues are payments by individuals to a public authority to enable the individuals to sell their goods in the market
- Rent on government property. Government rents out her property to individuals and organizations and generates some income
- Surplus from gambling. This is one of the ways of mobilizing capital through sales of raffles and organizing lotteries
- Printing of money by the central bank. The government may request the central bank to print more paper notes and mint more coins in order to raise funds for her expenditure
- Compulsory saving schemes, for example, insurance and NSSF. The government the compulsory saving schemes social security funds, insurance payments

TAXATION

What is a tax?

A tax is a compulsory contribution levied by a public authority irrespective of the exact amount of service rendered to the tax payer in return

It is a legally compulsory transfer to wealth from the public (households and firms) to the government as a source of government revenue to meet needs to residents

In other words, a tax is a non-quid pro quo compulsory payment made to the fiscal authority for the administration of social services to the public as a whole

A subsidy is a negative tax and it is a transfer of resources (funds) from the government to the individual economic units

CANNONS OR PRINCIPLES OF TAXATION

Cannons of taxation refer to the governing laws of taxation. These canons or principles include

- Simplicity. The tax system should not be complicated. The nature of the tax, the mode of assessment and collection should be simple to understand by both the tax payer and tax collector
- Equity or fairness. Tax payers should bear at least a proportionately equal burden of taxation. Those whose earn more should pay more taxes than the poor. The rich should thus pay proportionately more income than the poor
- Elasticity or flexibility. The tax rate should change according to changes in tax bases. For example, should change with changes in tax payer's income. Tax rates should increase when incomes increase and decrease when incomes fall
- Diversity or comprehensive. It should cover a wider range of bases. There should be a variety of taxes so that all citizens should contribute towards state revenues according to their ability to pay. There should be a variety of direct and indirect taxes
- Optimality. There should be a minimum balance between the amount of revenue collected, the services rendered through public expenditures and the work effort forthcoming from the tax payers in order to increase productive output
- Convenience. Taxes should be collected at the time which is convenient to the tax payer in respect of time, season and availability of income. Taxes should be collected at a time the tax payer has earned income but not after the tax payer has had opportunity to spend it
- Economy or cheapness. The cost of collection should be low to enable tax authorities realize enough revenue for the public authority. The cost of collection should not exceed 5 per cent of its yield
- Neutrality or impartiality. It should not discriminate tax payers
- Consistency. It should be in line with national economic objectives, especially in allocation of resources
- Certainty. The nature of the tax, its base, the amount to be paid, when to pay and where to pay the tax should be known to both the tax payer and tax collector. Certainty also means that the state should also be certain about the amount of tax revenue and the time when it is expected to flow into the treasury
- Productivity. Productivity of a tax means that a tax should bring large revenue which should be adequate for the government. The government should not however, in a bid to raise revenue, overtax people so that taxation adversely affects the productive capacity of the economy. A tax should not therefore, discourage investment or economic activities on which it is imposed
- Avoid double taxation. A tax payer should not be taxed more than once on the same tax base. For example, pay as you earn, surtax and graduated tax are taxes imposed on the same tax base, personal incomes

CHARACTERISTICS OF TAXES

A good tax system should be/is

- Simple, this states that a tax should be easily calculated and understood by both taxpayer and tax collector
- It is equitable or fair, the burden of tax payment should fall equitably on all the tax payers
- Flexible or elastic, this emphasizes that a tax should be altered (changed) according to prevailing conditions in the economy
- Comprehensive, a good tax should have a wider source or base
- Optimal, there should be a minimum balance between the amount of revenue collected, the services rendered through public expenditures and the work effort forthcoming from the tax payers
- Convenient; when and how to pay the tax should be convenient to the tax payers
- Economical; the cost of tax collection should be low
- Neutral/impartial; this states that a tax should not discriminate among tax payers.
- Consistent; a good tax should be in line with national economic objectives, especially in allocation of resources
- Certain; a good tax is one whose base, time of payment and amount to be paid are known
- Avoid double taxation; a good tax should not be imposed twice on the same tax base.
- Have a build in stabilizer, a good tax should have a stabilizing influence on the economy

THE PURPOSE/OBJECTIVES/AIMS OF TAXATION

Reasons why government levies taxes

The socio-economic reasons as why governments levy taxes on citizens may include;

- To raise revenue for recurrent and development expenditure. Taxation is undertaken to raise government revenue to enable her meet her recurrent and development expenditure needs such as payment of wages, provision of infrastructure and provision of public utilities and public goods
- For purpose of reducing disparities/difference in the distribution of income. Taxation is carried out in order for the government to reduce income inequality in the country by taxing the rich more heavily than the poor and subsidizing the poor using the revenue raised through taxes
- To discourage consumption of undesirable products. Taxation is carried out to discourage production and consumption of demerit goods. Heavy taxes are imposed on such products as wine and cigarettes to make them less profitable to producers and less affordable to consumers and protect consumers' health
- To protect local industries/firms and domestic producers. Taxation is undertaken so that local industries are protected from competition by foreign producers through imposition of heavy duties on imported products that compete with locally produced products. This makes locally produced products more competitive than imports
- For controlling demand pull inflation hence price stability. During inflationary periods, heavy taxes are imposed on incomes to reduce disposable incomes and aggregate demand and control demand pull inflation
- To control dumping. The government imposes very high import taxes on cheap, imported products so as to avoid selling these products in the economy at a giveaway price
- To improve on the county's balance of payment (BOP) position. Taxation is undertaken to correct balance of payments disequilibrium through discouraging of expensive importation by imposing heavy taxes on imports. Heavy import duties make imports very expensive and less competitive at home thus reducing expenditure abroad
- To control monopoly power. Taxation especially the specific and lump sum taxes reduce monopoly profits derived by controlling output and charging high prices. This forces monopoly to devise efficient production techniques so as to increase or maintain its profit margins thereby improving her efficiency in resource utilization

- For purpose of influencing resource allocation. Taxation is a device for allocation and regulation of the use of resources for example by taxing heavily most profitable activities to prevent fast exhaustion of resources and through reduction of taxes on socially desirable but less profitable activities to encourage allocation of resources to their use
- To facilitate/regulate the process of economic growth. Taxation is an instrument for stimulating and guiding economic growth through giving of tax incentives such as tax holidays and tax reliefs to investors to encourage investment, output and economic growth.

FACTORS THAT INFLUENCE THE LEVEL OF TAX REVENUE IN DEVELOPING COUNTRIES

- The taxable capacity, a high taxable capacity implies that there are more people with high incomes that can be subjected to heavy taxation which results in high tax revenue collected while low taxable capacity implies that there are many people who have extremely low incomes that cannot be subject to taxation while others due to their low incomes cannot pay heavy taxes resulting in low tax revenue collected
- The degree of accountability by tax officials. High degree of accountability by the tax officials results into increase in tax revenue yet corrupt tax officials embezzle revenues collected through taxation resulting in low revenues for the government
- The level of tax evasion; a low level of tax evasion implies that may tax payers are meet their tax obligations which result in increase in tax revenue yet a high level of tax evasion implies that many tax payers out rightly dodge tax payments. This limits tax revenue realized by the government because evasion reduces the number of tax payers
- The level of tax avoidance; a low level of tax avoidance implies that majority of the tax payers are responding to the relevant tax lows to meet their tax obligations leading to increase in tax revenue yet a high level of tax avoidance implies that many would be tax payers use the loopholes in the tax laws to avoid tax payment. This is done by substituting taxes activities by untaxed ones or by declaring imported manufactured goods as intermediate products to be used in the production process thereby avoiding payments of taxes
- The availability of data or information; increased availability of data on people's incomes results into proper assessment of all tax payers which leads to high revenue generation yet limited data or information on people's incomes/wealth implies that some tax payers' sources of incomes are not wholly known to the tax authorities because income earners conceal information about their incomes to avoid tax liabilities. This results in low revenue realized
- The cost of tax collection; low cost of collecting and administration of tax because of the co-operation of tax payers results in a small percentage of the tax revenue being spent on its collection hence raising more tax revenue yet high cost of collecting and administration of tax especially income taxes would involve the use of many officials to coerce reluctant tax payers to pay the taxes. This results in a large percentage of the tax revenue being spent on its collection
- The skills of tax administrators/collectors. The provision of skills through training of tax officials on proper identification of tax base, proper tax assessment and skills in handling tax payers when collecting bases ensures compliance in tax payments leading to greater tax revenue while poor tax administration (limited skilled tax administrators) results in tax payers' resentment hence low compliance rate. This is because most tax officials are not properly trained on how to collect revenue without use of brutal means. This makes tax payers to hate tax payments instead of paying the taxes leading to low tax revenue
- The level of development of infrastructures, highly developed infrastructure increase accessibility to tax bases in remote areas by tax collectors thus high revenue is collected while poor infrastructure in form of poor roads limits their accessibility to tax payers' thus low revenue collected
- The level of monetization or commercialization of the economy; high level of monetization (commercialization) of the economy implies that a large proportion of the population produce for exchange thus more incomes to be taxed leading to greater tar revenue yet a large subsistence sector

implies a large proportion of the population produces for own consumption not for exchange. Such producers therefore, do not have tax incomes. This results in low tax revenue

- The tax rates; fair tax rates imposed on tax payers results into increased tax compliance hence more tax revenue generated yet low tax rates imposed on tax payers implies that may tax payers pay less tax than they are capable of doing hence low tax revenue
- The political climate. Political stability increases the level of economic activities on which taxes are imposed due to increased investor confidence in the economy and also enables tax collectors to go to all areas of the economy where there are tax payers without fearing for their lives hence greater tax revenue generated while political instability scares tax collectors from collecting taxes from areas experiencing instability due to fear for their lives. This results in low tax revenue raised
- The level of tax incentives to potential tax payers. The removal of tax exemptions results into high revenue realized because may bases are subjected to taxation yet tax exemptions whereby the government grants tax holidays, tax relief and tax concessions given to importers aimed at promoting regional co-operation limits tax bases. This leads to low tax revenue because many bases are not subject to taxation.
- The level of satisfaction of tax payers with services provided by the stated. Proper and effective use of the tax revenues through provision of essential goods and services that are beneficial to society encourages tax payment leading to high tax revenue yet misuse of tax revenues increases resistance to tax payment among tax payers leading to low tax revenue generated
- The number of economic activities/tax base; diversification of the economy increases the number of economic activities on which taxes are to be imposed leading to high tax revenue generated yet a narrow tax base implies that there are few economic activities on which taxes are to imposed hence tax revenue raised is low.

REASONS FOR LEVYING DIFFERENT TYPES OF TAXES IN AN ECONOMY

Public authorities, especially the state, impose several types of taxes both direct and indirect. The rationale for imposition of different taxes includes

- To widen the taxable base and sources of revenue. Imposition of many taxes enables government to diversify its sources of revenue. The yield from different taxes is much higher than the yield from only one type of tax
- Revenue from only one source of tax is uncertain. Revenue from different tax bases vary from time to time yet the government needs revenues to meet her expenditure at all time. Imposition of different taxes ensures certainty of flow of revenue at all times
- To achieve a high degree of progressivity in the tax system. Imposition of different taxes makes the rich to pay more taxes than the poor, directly and indirectly, thereby taxing the rich more than the poor leading to achievement of progressivity in the tax system
- To enable the government fulfill many of her obligations regarding finance by raising adequate revenue. Government has many financial obligations such as payment of wages, debt retirement and provision of social services. Thus, the need to levy different types of taxes to raise huge amounts of income to meet government obligations
- To balance the effect of taxes on savings, consumption and investment. Several taxes are imposed to enable government raise adequate revenue by not acting as a disincentive to work, savings, consumption and investment. Thus the government levies different taxes to avoid excessive negative effects of taxation on the economy
- To forge equity in income distribution. Through imposition of several taxes, the rich pay more taxes than the poor. This limits the income gap between the rich and the poor from widening if the poor pay few and proportionately lower taxes than the rich
- To minimize dependence on foreign sources of revenue. Many taxes help government to raise reasonable amount of revenue locally, thereby minimizing her dependence on external borrowing to fill her revenue – expenditure gap

- To control inflation. Through multiplicity of direct taxes such as pay as you earn (PAYE), surtax, graduated tax and corporate taxes, disposable incomes and aggregate demand are reduced thereby reducing inflationary pressures on the economy
- To solve balance of payments deficits. Many taxes are imposed on imported goods to make them expensive and discourage their importation, reduce expenditure abroad and improve balance of payments position.
- To control harmful consumption. Taxes are used to discourage consumption of undesirable products by making the products more expensive than their factor costs. This is done to discourage consumption of demerit goods and ensure a healthy population

PROBLEMS/CHALLENGES FACED BY TAX AUTHORITIES IN UGANDA (A summary)

- High level of tax evasion
- Low taxable capacity
- Shortage of skilled manpower
- Poor infrastructure
- High rate of corruption
- Political instability in some parts of the country
- Conflicting government objectives/polices
- Political interference
- Resistance from the public against tax payment
- Difficulty in identifying taxable sources
- Frequent changes in employment or contacts and residence (large informal sector)
- High level of tax avoidance

PROGRESSIVITY OF A TAX AND TAX RATES

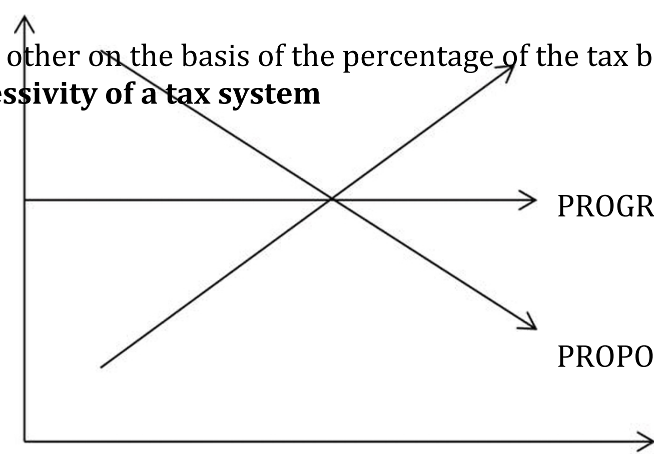
Progressivity of a tax refers to the relationship between income and the percentage of the income paid as tax
A tax rate on the other hand is the proportion of income paid as tax
Tax rates show the way in which the ratio of tax to income varies. According to the ratio of income taken by a tax, taxes can be group into

- Proportional tax
- Progressive tax
- Regressive tax
- Digressive tax

These differ from each other on the basis of the percentage of the tax base paid on tax

Illustration of progressivity of a tax system

TAX RATES



PROGRESSIVE TAX

PROPORTIONAL TAX

REGRESSIVE TAX

0 INCOMES

PROPORTIONAL TAX
This is a tax which takes a fixed proportion of one's income
Or
It is a tax which is levied at the same rate at all income levels
Or
It is a tax whose rate remains constant at all levels of income
Its percentage remains the same regardless of the size of the tax base. If the rate is 30% then every person shall pay tax at this rate

Merits
- It is simple to apply/easy to calculate. It is easy for every person to calculate the amount of tax he is required to pay
- It is simple to understand. It is very simple and everybody can understand it without much difficulty. Therefore, it can easily be administered

This tax is considered a fair system of taxation

Demerits
- It tends to discriminate against low-income groups. This tax system in inequitable because it adversely affects the low income groups and favours the high income groups
- It increases income inequalities. It increases inequalities in income because the rate of income remains the same yet incomes of the rich increase at a faster rate than the incomes of the poor
- Less productive than progressive taxes. It is not productive because it does not bring enough revenue to the treasury due to constant tax rate
- Lowers the level of savings and consumption in the economy. By taxing the high and low income groups at the same rate, this tax system proportionately taxes away a large percentage of the low income groups thereby adversely affecting their incomes, consumption and savings

PROGRESSIVE TAX
This is a tax whose rate increases with increase in income of the of the tax payer
Or
Is one whose rates rise as the spending power increases
Or
It is a tax which takes a higher (larger) proportion of incomes of the rich than the poor. Its rates increases as the tax base (income) increases. Therefore, as the income increase, the tax rate also increases gradually but the tax rate falls as income declines.
It is graduated so that a person with a higher income pays a greater percentage in tax than a person with a lower income

Merits of progressive taxes
- Productive. Progressive taxation is highly productive because it yields more revenue to the government. Government increases its income by raising the rate to meet her expenditure needs
- Reduces inequality of incomes. It reduces inequality of incomes and wealth in the economy when the rich are taxed at a higher rate than the lower income groups
- Helps creates economic stability for example control inflation. Progressive taxation helps establish economic stability by reducing the tax rates during a recession to increase aggregate demand as a result of which investment is encouraged. During boom or inflationary periods, tax rates are increased to reduce aggregate demand thus stabilizing the economy

- Better use of resources by taxing heavily incomes that would have been used for harmful and wasteful consumption. By taxing luxuries and incomes of the rich people are limited from putting their resources to undesirable uses
- Elastic. The tax system is elastic because the government can change the tax rates whenever it needs extra income or wants to give relief to low income groups
- Economical. Progressive taxation is economical because the cost of collection taxes does not increase when the tax rates are increased

Demerits of progressive taxes
- Discourages capital formation
- It is disincentive to hard work
- Tax evasion and avoidance is encouraged

Reasons for imposing progressive taxes
- To reduce income inequality
- To raise revenue for the government
- To raise revenue for the government
- To control (demand pull) inflation

Effects of progressive tax system in Uganda
- Leads to increased government revenue
- Promotes fair income distribution
- Helps to fight demand pull inflation
- It is a disincentive to effort
- Discourages savings
- Arouses resentment
- Tends to discourage investors

REGRESSIVE TAX

A regressive tax is one whose tax rate is higher on low income earners and lower on high income earners
The rate of the tax increases as the tax base decreases and decreases as the tax base increases. A high income earner pays less tax in proportion of his income than a lower income earner under the regressive tax regime

The table below explains a regressive income tax

Tax base in shs	Tax rate (%)	mount of tax in shs
100,000	60	60,000
200,000	50	100,000
300,000	40	120,000
400,000	30	120,000
500,000	20	100,000
600,000	10	60,000

Thus the lowest income earner pays a much higher tax rate of 60% while the highest income earner pays the lowest tax rate of only 10%

Advantages of regressive taxes
- Leads to low rates of tax evasion and avoidance by the rich
- Encourages savings, investment and capital accumulation by the rich

- Encourages hard work and thrift so as to meet the low income tax rates at the upper income levels
- Attracts foreign capital transfers by the rich from other countries when escaping high taxes abroad

Disadvantages of regressive taxes

- Limits consumption of masses consumer goods such necessities/reduces aggregate demand
- Increases inequality in income distribution, that is, it widens the gap between low income people and high income people
- Stirs/arouses social unrest
- Leads to low tax revenue to the government due to tax avoidance and evasion by the poor

Example

A multi citizen man lived in three countries, each of which operated a system of personal income tax. The table below shows the amount of tax he would have had to pay at different levels of income in the three countries

Income level ($)	**TAX PAID $**		
	Country A	**Country B**	**Country C**
16,000	1,600	1,200	1,200
18,000	1,800	1,400	1,200
20,000	2,000	1,600	1,200

From the table above, state with reason the type of tax imposed in each country

TAX PAID IN COUNTRY A

1600 x 100
16000
= 10%

1800 x 100
18000
= 10%

2000 x 100
20000
= 10%

It is a proportional tax because the tax rate is the same regardless of the level of income

TAX PAID IN COUNTRY B

1200 x 100
16000
= 7.5%

1400 x 100
18000
= 7.5%

1600 x 100
20000
= 8%

It is a progressive tax because as one's income increase, the tax rate also increases

TAX PAID IN COUNTRY C
1200 x 100
16000
= 7.5%

1200 x 100
18000
= 6.5%

1200 x 100
20000
= 6%
It is a regressive tax because as the income increases, the tax payer pays less of the tax

MORE TERMS ~~USED IN~~ RELATION TO TAXATION
Average rate of tax. This is the ratio or percentage of a tax payer's income that is paid as a tax. It is the ratio to the taxed income
It is derived by diving total tax by one's total income

ART = Total tax x 100
Total income

Or it is obtained by dividing a person's tax liabilities by his income base

ART = Tax liability x 100
Tax base

For example if a tax payer earns four million shillings per annum and the tax liability is shs 250,000; the tax payers average rate of taxation is

ART = 250,000 x 100
4,000,000
= 6.25%

Marginal rate of a tax; is the percentage or ~~proportion of~~ addition income paid as tax
Or
This is the amount of tax one pays on additional income

Marginal rate of a tax (MRT) = Increase in tax x 100
Increase in income

For example if income increased from shs 500,000 to shs 800,000 and a tax payer's liability increased from 50,000 to 80,000 shillings, the marginal rate of a tax is

MRT = 80,000 – 50,000 x 100
800,000 – 500,000
= 10%

Dead weight tax refers to a tax which discourages the economic activity on which it is imposed from continuing

Marginal sacrifice of a tax refers to the extent to which the announcement effect of a tax imposed makes the tax payer to reduce the amount of work applied before the tax was imposed

STRUCTURE OF TAXATION (TAX STRUCTURE IN UGANDA)
Uganda's tax structure is based on direct and indirect taxation.

DIRECT TAXES
Direct taxes are those taxes levied directly on incomes and property of individuals and enterprises such that the incident of the tax rests on the tax payer concerned and cannot be shifted to another person for example personal income tax, property tax, corporate tax etc
Or
Is one which is levied on the income and/or wealth of an individual of firm and the individual or firm bears the whole tax burden

With direct taxes the person on whom the tax is levied pays the tax directly to the revenue authorities, for example, ministry of finance

CHARACTERISTICS/FEATURES OF DIRECT TAXES
(i) Burden normally falls directly on individuals concerned, that is, the tax cannot be shifted onto another person
(ii) Paid on income/property
(iii) Imposed in relation to the size of income or property
(iv) Takes into account the resources or the income (wealth) and how it is paid
(v) Varies with financial status of the taxpayer

FORMS/EXAMPLES OF DIRECT TAXES

Income tax is a direct tax levied on the earnings/income(s) of individuals (households) and firms and the burden of the tax is borne by the individuals or firms on which it is imposed
Income taxes are referred by tax payers because of being fair, certain and convenient

Capital gains tax: is a tax levied on financial assets whose values have increased from the time of their purchase to the time of their sale
Or
A direct tax levied on the increase in the monetary value of an asset between the time of acquisition and the time of its sale

Profit or corporate (corporation) or company tax; is a tax levied on profits of companies
Demerits of corporation tax
- Discourages investments
- Hampers ploughing back of capital
- Encourages tax avoidance
- Encourages resentment
- Encourages tax evasion
- Discourages innovations

Death/estate duty; tax levied on deceased person's property before the property is distributed to heirs so as to reduce income inequality. Estate duties are progressive in nature and are paid by the heirs but sometimes are defined property tax and therefore should be paid by the owner

Gift tax; this is a tax levied on gifts among the living or the transfer of wealth from one person to another

Graduated tax; tax on every adult citizen (excluding full time students housewives/women and the unemployed) paid to the local authority/local government

Wealth tax; tax on past accumulated savings of a person
Or
A tax imposed on an individual's stock of wealth

Land tax; this is imposed on holders of land for commercial activity (agriculture) or not very pronounced in east Africa although it can be a fruitful source of income for the governments

Impacts of direct taxes on an economy
Positive impact
- Means of acquiring public revenue. Direct taxes are imposes on tax payers to raise revenue for the government to enable her meet her recurrent and development expenditure needs.
- Controlling inflation. During inflationary periods, heavy direct taxes are imposed to reduce disposable income and the level of aggregate demand and control demand pull inflation
- Equitable distribution of income. Direct taxes help in redistribution of income through taxation of the rich more heavily than the poor (and subsidization of the poor using the tax revenue)
- Regulating/contolling monopoly power. Direct taxes reduce monopoly profits and force the monopolist to devise efficient production techniques so as to increase output but lower production costs thereby improving her efficiency in resource utilization
- Encourages economic growth/production levels. Direct taxes are an instrument for stimulating economic growth through provision of tax incentives such tax holidays to investors to lower production costs, increase profits, encourage investment, increase production hence economic growth
- Promoting hardwork/initiative. Through direct taxation, people are forced to work hard to increase incomes and remain with sufficient disposable incomes to maintain the standard of living that they are accustomed to
- Influencing resource allocation for example corporate tax. Heavy direct taxes are imposed on firms in sectors that use non-renewable resources to increase production costs while provision of tax incentives to firms in socially desirable but less profitable activities encourages the allocation of resources from the highly taxed to less taxed activities

Negative impact
- Discouraging investment. Fear of payment of heavy corporate taxes that reduce profits discourages entrepreneurship
- Discoursing savings. Direct taxation discourages savings by taking away earnings which would have been put aside for future investment. The would have been savings are transferred by force from individuals to government through taxation
- Reduces the welfare of the people due to reduced consumption. The welfare of citizens is reduced because direct taxes take away part of the income that could have been used for consumption hence making consumers to afford fewer quantities and varieties of goods
- Discourages effort and initiative. High progressive taxes discourages people from working hard and from taking initiatives when increase in incomes results in paying more taxes than before, thus making them feel they do not sufficiently benefit from their sweat
- Creates resentment among the people that may erode the popularity of government. Direct taxation leads to economic hardships such as inability f people to afford essential goods, reduced producer

profits and collapse of businesses due to reduced market and profits. This costs government her popularity and may lead to tax payer riots hence political unrest in the country

- Led to resource misallocation. Direct taxation encourages resource diversion from highly taxed activities to sometimes non-productive ventures which are not taxed and may not be productive or essential in the economy
- Worsens income inequalities for example regressive taxes. Regressive taxes especially taxes on essential goods and services on which the poor spend the greatest proportion of their incomes tend to lead the poor worse off than the rich
- High cost of administration and collection by the government. Direct taxes impose a high cost on government because they involve use of many officials to coerce reluctant tax payers to pay the income taxes. This results in a large percentage on the tax revenue being spend on its collection

ADVANTAGES OF DIRECT TAXES

1. It is elastic and high yielding. It contributes to approximately 2/3 of total revenue
2. It is convenient as its collection is during appropriate time
3. It is progressive – redistributes income and hence reduces income inequality between individuals
4. Proves to be a more assured source of government because the revenue from direct taxes can easily be estimates to enable the government plan for the funds well in advance
5. Direct taxes have an advantage of being used as a measure against inflation
6. The cost of collection is low (it is economical) this is exemplified in the case of PAYE where employers act as tax collectors for the government
7. Direct taxes fulfill the principle of certainty ie payers know how much, when and where to pay
8. A weapon against monopoly practice
9. Very fair because it considers taxable capacity of a payer
10. Direct taxes are built in stabilizers of an economy
11. Direct taxes create a sense of citizenship. By way of obligation it encourages effort and sense of responsibility

DISADVANTAGES OF DIRECT TAXES

1. Direct taxes discourage effort since they fall on one's hard earned income hence is a disincentive to hard work
2. They are difficult to review in a short run to raise revenue that is urgently needed
3. High direct taxes reduce the level of savings in an economy
4. May cost a regime (or government) political popularity, in other words high direct taxes may make a government (regime) unpopular
5. They discourage entrepreneurship in the case of high company taxes
6. Heavy direct taxes prompt payers to develop tendency of avoidance and evasion
7. Low yield in economies with low taxable base
8. These taxes at times tend to discriminate payers impartial
9. Uncertain in LDCs where there is much corruption
10. Cost of collection in totality is high. Many are involved in assessment, collection an netting defaulters
11. High rate of direct taxation is a disincentive to investment

INDIRECT/HIDDEN/EXPENDITURE/OUTLAY TAXES

Indirect taxes are those that are levied on goods and services and a person who pays the tax can pass or shift it onto another person in form of high prices for example import duties, export duties, value added tax etc

Or

Are taxes levied on goods and services and only paid when consuming a good or service. The burden can be shared between the seller and buyer

CONTRIBUTION OF INDIRECT TAXATION IN THE ECONOMIC DEVELOPMENT OF UGANDA

- Contributing to public revenue. Indirect taxation is a source of government revenue to enable her meet her recurrent and development expenditure needs such as payment of wages, provision of infrastructure and provision of public utilities and public goods
- Improving balance of payments (BOP) position. Indirect taxation helps in correcting balance of payments disequilibrium through discouraging of expensive importation by imposing heavy taxes on imports. Heavy import duties make imports very expensive and less competitive at home thus reducing expenditure abroad
- Influencing resource allocation. Indirect taxation is a device for allocation and regulation of the use of resources for example by taxing heavily most profitable activities to prevent fast exhaustion of resources and through reduction of taxes on socially desirable but less profitable activities to encourage allocation of resources to their use
- Discouraging production and hence consumption of demerit goods. Indirect taxation is used to discourage production and consumption of demerit goods. Heavy indirect taxes are imposed on such products as wine and cigarettes to make them less profitable to producers and less affordable to consumers and protect consumers' health
- Protecting domestic firms. Local industries are protected from competition by foreign producers through imposition of heavy duties on imported products that compete with locally produced products. This makes locally produced products more competitive than imports
- Discouraging dumping. Anti-dumping duties are levied so as to shield the domestic market against foreign goods dumped at very low or below cost prices for instance, plastic products imported from china, which can be cheaper than the domestic market rates
- Controlling monopoly power. Indirect taxation especially the specific and lump sum taxes reduce monopoly profits derived by controlling output and charging high prices. This forces monopoly to devise efficient production techniques so as to increase or maintain its profits margins thereby improving her efficiency to resource utilization
- Influencing level of economic growth. Indirect taxation is an instrument for stimulating and guiding economic growth through giving of tax incentives such as tax holidays and tax reliefs to investors to encourage investment, output and economic growth

FORMS OR EXAMPLES OF INDIRECT TAXES

- Sales tax: this is a tax on all retail sales which is usually borne by the seller
  Or
  Is a tax levied on manufacturers whenever they sell units of their commodities

- Excise duty; is a tax levied on home (locally) produced goods, whether for local consumption or exports
  Or
  Is a tax imposed on a productive activity or goods produced in a country

- Customs duty; is a tax that is imposed on goods entering a country
- Export duty; is a tax on goods leaving the country
- Import duties are taxes imposed on goods entering a country

NB Import duties are levied as specific or advalorem taxes

- A specific tax is an indirect tax levied as a fixed amount per unit of a commodity (irrespective of its value)
  Or
  Is one levied on a good depending on its quantity

While

- Advalorem tax is an indirect tax levied on a good depending on its value
  Or
  Is one levied on a good as a percentage of its value

Consumption tax is an indirect tax levied on consumer goods and services and the burden of the tax is borne by the consumer
Or
Is a levy or charge on consumption expenditure of an individual consumption unit. It is levied on goods as an indirect tax
A consumption tax is preferred because it is flexible and productive due to the wider base

Octorol tax is a tax imposed on goods which are in transit to one country through the territory of another country

Sumptuary tax – a form of (sales) tax mainly imposed on luxurious goods to curtail their consumption
Or
Is a tax imposed on the consumption of commodities, which are considered harmful/dangerous to the society as a way of discouraging their consumption

Turnover tax is a tax levied on the total sales of the business regardless of the state of production and distribution (where retail or wholesale trade)

Value added tax (VAT) is a tax imposed on the increase in value of a commodity at each stage of production
Or
Is a tax levied on the value of a commodity at each stage of production

Advantages of VAT
- It avoids double taxation
- It is difficult to evade
- Brings efficiency in business management because it encourages proper maintenance of books of accounts
- It is economical in terms of administration and collection
- It reduces corruption since there is direct payment to the tax authority
- It leads to increase government revenue because it is comprehensive
- It is not a disincentive to resource allocation because it does not lead to shifting of resources to other areas
- It encourages exports because taxes on exports are refunded hence improving the BOP position

Disadvantages of VAT
- It is not easily understood by the some taxpayers
- It is difficult to determine as most traders do not keep records
- It may be costly to administer as the tax collectors have to deal with many tax payer
- It increases the cost of production and the prices of final goods and services
- It tends to be proportional hence injuring small firms more than the big ones

ADVANTAGES OF INDIRECT TAXES
- Indirect taxes are convenient to the government
- They are flexible can be varied easily to meet desired objectives of the state

- They tend to contribute more to government revenue since cost of collection is low
- Indirect taxes promote hard work, in an endeavor for a consumer to meet the high prices caused by the taxes to maintain his standards of living
- They assist in combating BOP problems
- They are difficult to dodge/evade as goods and service must be purchased
- Safeguard the health of the citizens; this is the case with taxes on opium, narcotics and alcoholic drinks
- They help to protect infant industries from competitive imports
- They reduce resentment (ill will) of taxation. By taxing commodities people don't realize they are paying taxes
- Indirect taxes can be employed to stabilize an economy, for example, by imposing taxes on imported goods excessive importation is avoided

DISADVANTAGES OF INDIRECT TAXES

- It can easily spark off inflation most especially wine high rates are levied
- High indirect taxes may lead to malpractice, for example, smuggling
- Indirect taxes when imposed on necessities become regressive in nature thus discriminate against the poor
- It can reduce economic welfare since the poor won't cope with increment in prices
- Indirect taxes increase production costs to firms and if no checked may lead to closure of some firms
- Indirect taxes, for example, customs duties and export duties interfere with free trade, thus they tend to reduce exchange and specialization
- Protected industries may lead to higher prices and low quality products in domestic economy
- Fluctuates a lot (ie depending on volume of exchange) makes planning based on projected income difficult

AN ASSESSMENT OF THE IMPACT OF INDIRECT TAXES IN UGANDA

Positive impact of indirect taxes in Uganda
Positive impact of indirect taxes in Uganda is as follows
NB candidates/Students **MUST NOT** present advantages of indirect taxes but most bring out the impact/effect of these taxes on Uganda's economy

TENSE ACCEPTED = IS/HAS/DOES

- ❖ Protected domestic firms/industries. Local industries are protected from competition by foreign producers through imposition of heavy duties on imported products that compete with locally produced products. This makes locally produced products more competitive than imports
- ❖ Promotes efforts of the citizen or people in the economy. This is because they are levied on final goods and services but not on people's incomes hence they encourage production
- ❖ Discouraged the consumption of demerit/harmful goods. Indirect taxation is used to discourage production and consumption of demerit goods. Heavy taxes are imposed on such products as wine and cigarettes to make them less profitable to producers and less affordable to consumers and protect consumers' health
- ❖ Has influenced/influences investment, for example, investors produce more of those goods on which low indirect taxes are levied by government in order to reduce costs of production and increase profits
- ❖ Has improved/improve the balance of payments position. Indirect taxes are used to reduce the volume of imports through discouraging of expensive importation by imposing heavy taxes on imports. This reduces expenditure on imports and the balance of payments position is improved

- ❖ Has provided/provides revenue to the government. Indirect taxation is a source of government revenue to enable her meet her recurrent and development expenditure needs such as payment of wages, provision of infrastructure and provision of public utilities and public goods

Negative impact of indirect taxes in the economy of Uganda is thus

- ❖ Undermine volume and benefits of trade. Taxation especially high indirect taxes on imports limit the volume and benefits of international trade
- ❖ Tend to be regressive/promote income inequality. Regressive taxes impact more on the poor thereby widening income inequalities
- ❖ Lead to reduced consumption hence there is reduced consumers' welfare. Indirect taxes increase the prices of final products making consumers to afford less consumer goods and services than before tax hikes. This lowers the level of consumption both qualitatively and quantitatively hence lowering the standard of living of the people
- ❖ Promoted trade malpractices such as smuggling. High indirect taxes encourage mal-practices such as under-declaration, falsification of documents and smuggling in order to evade payments of taxes
- ❖ Tend to be inflationary/lead to cost-push inflation. A case of the high indirect taxes on fuel in Uganda which has increased the cost of production. This is because the producers shift the tax burden to consumers inform of increased prices
- ❖ Lead to resentment of government/lead to traders' unrest. Heavy indirect taxation causes resentment of the government of the day. It may lead to tax payers'/traders' riots and their call for the resignation or topping of the government of the day
- ❖ Discourage investment. Fear of payment of high indirect taxes discourages entrepreneurs from investing in an economy so at to avoid the taxed activities
- ❖ Lead to misallocation of resources as investors resort to producing goods on which the government is levying low or no indirect taxes. Taxation leads to resource diversion from highly taxed activity to sometimes low taxed non-productive ventures/areas. This results into resource misallocation
- ❖ Result into increased cost of production. Indirect taxes lead to increased production costs leading to closure of some firms/reduced producer profits/unemployment due to closure of loss making firms
- ❖ Breed inefficiency in those protected firms. Protected firms tend to remain infant and they don't expand since they are shielded from external competition

Reasons for preference of indirect taxes in my country include

- They are less felt and resented. Indirect taxes are not easily felt by the tax payers since they are included in the prices of the goods
- They are more reliable and greater source of revenue. Indirect taxes can be levied on a variety of commodities. Therefore, they are levied to ensure a continuous an sufficient flow of revenue to government unlike direct taxes that have few bases
- They are used to check on consumption of harmful goods. The state levies heavy duties on such articles of consumption such as alcohol, cigarettes and other intoxicants which are dangerous to the health and efficiency of the people. As a result, their prices rise and their consumption is reduced
- They help to improve on balance of payments position. When government wants to correct balance of payments disequilibrium, it imposes heavy import duties and low export duties. This reduces the volume and expenditure on imports thereby improving the balance of payments position of an economy
- They are less avoided. They are difficult to avoid because they are imposed on consumer goods and services. Consumers cannot avoid paying the taxes due to difficulty in avoiding consumption of taxed goods
- They are less evaded. There is less evasion because they are included in the prices of commodities. As these taxes are shifted onto the final consumers, producers and sellers do not mind paying the taxes since they do not bear the direct burden of the tax

- They are convenient as they are paid when spending occurs. Indirect taxes are less inconvenient because they are paid only when a good or service is being bough thence when tax payers have incomes
- They are impartial hence do not discriminate. Indirect taxes are paid by everybody who engages in consumption of a good or service
- They do no negatively affect effort or initiatives because they are levied on final goods and services but not on people’s incomes
- They help in stabilizing economy. During inflationary periods, government can lower taxes on goods and services to lower costs and prices thus reducing inflationary pressure on the economy
- They are easier and more economical in collection. Indirect taxes are cheap to collect (economical). The taxes are cheap to collect because they involve low cost of collection. Producers and sellers collect the taxes and deposit them with the government
- They are flexible or elastic. Indirect taxes are flexible or elastic because the government can reduce or increase the tax rates of say, excise duties on customs duties according to their requirements

REASONS WHY DEVELOPING COUNTRIES RELY MORE ON INDIRECT TAXES THAN DIRECT TAXES

- Indirect taxes yield higher revenue because they have a wider coverage than direct taxes
- Indirect taxes are difficult to avoid and evade compared to direct taxes since they are included in prices of commodities
- Indirect taxes are more economical in terms of collection compared to direct taxes with high costs of collection
- Indirect taxes are impartial yet direct taxes are not paid by all people
- Indirect taxes are more flexible since they can be adjusted according to prevailing conditions in the economy compared to direct taxes
- Indirect taxes are convenient to the tax payer since they are not paid in lump sum but in bit only when spending occurs unlike direct taxes which are paid in lump sum
- Indirect taxes are less felt and resented compared to direct taxes which cause political resentment and loss of political popularity
- Indirect taxes are not a disincentive to effort and initiative unlike direct taxes which discourage effort
- Low taxable capacity in an economy because of low incomes limits direct taxes thus more reliance on direct taxes

THE ROLE OF TAXATION IN AN ECONOMY

Positive role/merits of taxation

- Raises revenue for government. Taxation is a source of government revenue to enable her meet her recurrent and development expenditure needs such as payment of wages, provision of infrastructure and provision of public utilities and public goods
- Promotes fair income distribution. Taxation helps the government to reduce income inequality in the country by taxing the rich more heavily than the poor and subsidising the poor using the revenue raised through taxes
- Controls inflation. During inflationary periods, heavy taxes are imposed on incomes to reduced disposable incomes and aggregate demand and control demand pull inflation
- Improves balance of payments position. Taxation helps in correcting balance of payments disequilibrium through discouraging of expensive importation by imposing heavy taxes on imports. Heavy import duties make imports very expensive and less competitive at home thus reducing expenditure abroad
- Influences proper resource allocation. Taxation is a device for allocation and regulation of the use of resources for example by taxing heavily most profitable activities to prevent fast exhaustion of

resources and through reduction of taxes on socially desirable but less profitable activities to encourage allocation of resources to their use

- Stimulates economic growth. Taxation is an instrument for stimulating and guiding economic growth through giving of tax incentives such as tax holidays and tax reliefs to investors to encourage investment, output and economic growth
- Protects domestic firms from unfair competition by foreign industries. Local industries are protected from competition by foreign producers through imposition of heavy duties on imported products that compete with locally produced products. This makes locally produced produces more competitive than imports. Local firms are also protected from competition through being given tax holidays and through subsidization
- Discourages production and consumption of demerit goods. Taxation is used to discourage production and consumption of demerit goods. Heavy taxes are imposed on such products as wine and cigarettes to make them less profitable to producers and less affordable to consumers and protect consumers' health
- Controls monopoly powers. Taxation especially the specific and lump sum taxes reduces monopoly profits derived by controlling output and charging high prices. This forces monopoly to devise efficient production techniques so as to increase or maintain its profit margins thereby improving her efficiency in resource utilization
- Means of forced savings. Taxation transfers income that would have been used for wasteful consumption by individuals to the state that uses the incomes for public investment

Negative role/demerits of taxation

- Discourages investment. Fear of payment of heavy corporate taxes and high indirect taxes discourages entrepreneurs from investing in an economy so as to avoid the taxed activities
- Discourage savings. Taxation discourages savings by taxing away earning which would have been saved for future investment. The would be savings are transferred by force from individuals to government through taxation
- Leads to reduction in consumption and hence reduced welfare of the people. The welfare of citizens is reduced because direct taxes limit the size of disposable incomes that should have been used for consumption while indirect taxes increase the prices of final products making consumers to afford less consumer goods and services than before tax hikes. This lowers the level of consumption both qualitatively and quantitatively hence lowering the standard of living of the people
- Resource misallocation. Taxation leads to resource diversion from highly taxed activity to sometimes low taxed non-productive ventures/areas. This results into resource misallocation
- Reduces volume and thus benefits of trade. Taxation especially high indirect taxes on imports limit the volume and benefits of international trade
- Encourages malpractices and illegal activities like smuggling and corruption. High indirect taxes encourage mal-practices such as under declaration, falsification of documents and smuggling in order to evade payments of taxes
- Direct taxes discourage effort and initiative. High progressive taxes discourage people from working hard and from taking initiatives if they feel they do not benefit from the fruits of their efforts, that is, when increase in incomes results in paying more taxes than ever before
- Creates resentment amongst the public. This leads to loss of popularity by the government. Heavy taxation, especially direct taxes, causes resentment of the government of the day. It may lead to tax payers'/traders' riots and their call for the resignation or toppling of the government of the day
- Leads to income inequality. Regressive taxes impact more on the poor thereby widening income inequalities
- Increases production costs leading to closure of some firms/reduced producer profits/unemployment due to closure of loss making firms

- Leads to inefficiency of domestic (infant) firms which are shielded from external competition
- It is inflationary (the case with indirect taxes) this is because the producers shift the tax burden to consumers inform of increased prices

THE IMPACT, INCIDENCE AND EFFECTS OF A TAX

Incidence of a tax refers to the person who ultimately bears the (money) burden of a tax
Or
The final resting place of a tax

A person on whom a tax is imposed may shift the burden forward to a third party in form of price increases. The person who finally pays the tax bears the formal incidence of a tax while the person who shifts the burden of the tax bears the informal incidence of the tax

Impact of a tax refers to the person or firm on whom a tax is officially levied
Or
The person or company that directly and immediately bears the burden of a tax as soon as it is imposed
Or
The first resting place of a tax
Or
The immediate effect of a tax on a person on whom it is levied

SUBSIDY

A subsidy is money granted by the government to producers of goods and services to make their products cheaper or granted to an infant or strategic industry to make the products of the industry competitive both locally and internationally
Or
A subsidy is an amount of money given directly to firms by the government to encourage production and consumption
Or
Is monetary assistance granted by a government to a person or group in support of an enterprise regarded as being in public interest
Or
A subsidy is a benefit given by the government to groups or individuals usually in the form of a cash payment or tax reduction.

A subsidy has the following effects

- It lowers the producers' cost of production
- It increases supply of the good
- It leads to increased demand of the subsidized good

TAX BASE

A tax base is an item or entity on which tax is levied (by the government)
Or
The person or firm or source of income or the economic activity on which a tax is imposed

REASONS FOR THE NARROW TAX BASE IN UGANDA

- Poor infrastructure. The poor state of infrastructure makes it difficult to access bases in remote areas where there are economic activities on which taxes can be imposed

- Tax exemptions. Government grants tax holidays, tax relief and other tax concessions given to attract foreign investors, protect infant industries and promote regional co-operation. This limits the number of economic activities on which taxes are imposed
- Large subsistence sector. The subsistence producers do not receive money incomes on which taxes can be imposed because production is for own consumption leading to low tax base
- High unemployment level. Many people are unemployed and do not have incomes on which taxes can be imposed
- Political instability. Political insecurity makes it difficult to access the tax bases, some productive activities exist in areas where there is political unrest but tax officials are unable to access theme due to fear for their lives
- Poor identification of tax sources. Many income generating activities exist but because they have not been formally registered with the tax authority, they are not identified as tax bases
- Small industrial sector. The industrial sector is small and therefore, cannot provide wide enough bases for taxation, that is, there are few firms on which taxes are imposed
- Limited diversity of economic activities (limited diversification of the economy). The number of economic activities in the economy is not as many as they can be leading to few items eligible for taxation
- Limited skills of tax assessors. Tax assessors do not have sufficient skills to recognize all items and sources of incomes that are liable for taxation
- High level of corruption. Tax officials ignore economic activities that can be liable for taxation after receipts of (receiving) bribes by potential tax payers
- Limited information or data. Many people do not keep records of their economic activities and incomes. This limits accessibility by tax assessors to information to be used for identification of items to be taxed
- Frequent changes in employment, contacts and residence. This makes it difficult for tax officials to locate the economic entities or items that can be taxed

WAS THAT CAN BE TAKEN TO IMPROVE THE TAX BASE IN DEVELOPING COUNTRIES

NB: Focus: is on increase in the items on which taxes can be imposed not on increasing tax revenues

Ways that can be taken to improve the tax base in developing countries include;

- Ensure political stability (improve the political atmosphere); the government can reduce insecurity and political unrest so as to increase production activities and increase access to tax bases in all parts of the economy
- Expand/develop the industrial sector. Undertake massive industrialization within the agriculture sector especially the promotion of small scale industries which will widen the taxable base
- Commercialize the economy/reduce the subsistence sector/monetize the economy. Increase production for exchange can increase on the money incomes on which taxes can be imposed because production will be for the market
- Improve infrastructure. This can increase access to all parts of an economy where economic activities on which taxes can be imposed are carried out
- Diversify the economy. Broadening the tax base can be done through increasing the number of economic activities subject to full taxation. This can increase the number of items eligible for taxation
- Review the existing tax laws for example abolish or avoid unnecessary tax exemptions/tax holidays. Significant portions of national consumption are not included in the tax base, through deductions, exclusions, and other preferential tax treatment. Broadening the tax base can consist of ending tax preferences to raise revenue
- Further liberalize the economy. This can lead to increase in the number of economic activities on which taxes can be imposed. This may be due to the removal of unnecessary government controls on trade

- Further privatize the public enterprises. This can widen the tax base on private business firms due to the increased efficiency and expansion of businesses
- Diversify the taxes/introduce new different types of taxes, for example, on gambling activities such as sports betting, education tax on private education institutions etc
- Solve the unemployment problem. Broadening the salaries taxpayer base by significantly reducing unemployment can help widen the tax base. This would draw wage earners currently paying no salaries tax (PAYE) into the tax net hence widen the tax base as most of the workforce pay tax on their earnings
- Encourage proper record keeping/strengthen book-keeping. This can reduce under-assessment that can lead to low revenue generated and over-assessment that can lead to resistance of tax payment
- Promote proper accountability in business enterprises. Opportunities for corruption are pervasive in tax collection, hence a comprehensive anti-corruption strategy, including an effective internal audit function, can be essential in widening the tax base
- Maintain an up-to date register of tax payers/computerize the tax register. This can help the established semi-autonomous revenue agencies to take over tax collection with an up to date record of tax payers
- Promote modernization of agriculture to provide wide job opportunities in rural areas. This will develop into a prominent taxable base
- Train relevant and competent man power to ensure effective administration of tax system. Developing countries like Uganda have a relatively narrow tax base because of the limited skills of tax officials. Broadening the tax base requires stronger tax administration. Hence alongside tax policy reforms, institutional reforms have to be implemented. Training of tax administrators should be part of a broader effort to strengthen governance and improve public financial management

MEASURES TO INCREASE TAX BASES IN UGANDA – A SUMMARY

- Developing infrastructure
- Improve skills of tax administrators/officials
- Monetize the economy
- Promote industrial development
- Avoid unnecessary tax concessions and exemptions
- Liberalise trade
- Diversify the economy
- Privatize public assets/enterprises
- Encourage proper record keeping
- Improve political atmosphere
- Solve the unemployment problem
- Improve skills of tax officials

TAXABLE CAPACITY

Taxable capacity refers to the ability of the tax payer to pay a tax assessed on him and remain with enough/sufficient disposable income to enable him and his family to lead a standard of living they are accustomed to

Or

Taxable capacity of a nation is the ability of the government to realize sufficient revenue through taxation without producing harmful effects on the economy.

Or

The ability of the government to realize from the tax payers the revenues due to it from the taxes it imposes

DETERMINANTS OF TAXABLE CAPACITY IN DEVELOPING COUNTRIES

- The level of income of the tax payer. Taxable capacity depends on the size of personal income. The higher the personal income, the higher is the taxable capacity but the lower the personal income, the lower is the taxable capacity
- The tax rate, that is progressive, regressive or proportional. The progressive type of tax system has a high taxable capacity because it falls more heavily on the high income earners. On the other hand, regressive taxes which fall heavily on low income groups have low taxable capacity
- The price level/rate of inflation. The economic situation or price level determines taxable capacity. During inflationary situations, the real incomes of the people falls and their taxable capacity declines. Taxable capacity is high when prices are stable and real incomes are rising such as in boom situations
- The family size. The smaller the family size, the higher the taxable capacity, but the bigger the family size, the lower is the taxable capacity
- The consumption habits. If the consumption habits of the people are in such a way that they spend more on comforts and luxuries, their capacity to pay taxes will be lower than when their consumption habits are inclined to mass consumer goods
- The political atmosphere. Taxable capacity is high when there is political stability and low when there is political instability or the government is repressive and unpopular
- The number of tax bases. Taxable capacity depends on the number of tax bases that are productive. The more the tax bases, the higher the taxable capacity, but the fewer the tax bases, the lower is the taxable capacity
- The level of infrastructural development
- The efficiency of the tax administration
- The degree of accountability
- The degree/level of tax exemptions
- The level of evasion and avoidance of taxes

TAX AVOIDANCE AND TAX EVASION

Tax avoidance is the tax payer's exploitation of the loopholes in the tax laws so as to pay less (little) or no tax at all. It is legal

While

Tax evasion refers to the deliberate refusal by a tax payer to pay the tax assessed/imposed on him. It is illegal

Reasons why people evade tax payments in developing countries

- Unfair assessment
- Low income levels
- Discontent about provision of services by the government
- Lack of adequate information about taxes
- Desire to retain all earnings
- Laxity in the tax administration
- Lack of support for the government

Measures that should be taken to reduce tax evasion in Uganda

- Educate tax payers on the advantages of paying taxes
- Fight corruption
- Increase provision of services to the people
- Strengthen tax administration
- Ensure proper tax assessment
- Increase government popularity/acceptability with the population

PROBLEMS OF TAXATION IN UGANDA
(Causes of the relatively low level of public/tax revenue in developing countries like Uganda)

There are a number of problems limiting taxation potential in most developing countries like Uganda
These include

- Narrow tax base (few economic activities). These are few economic activities on which taxes can be imposed. Since there are few tax bases on which taxes can be imposed, tax revenue raised is low
- Large subsistence sector/limited commercialization. The subsistence sector is very large yet producers produce for own consumption not for exchange. Producers therefore, do not have taxable incomes. This results in low tax revenue
- High levels of tax evasion (include malpractices in trade). Many tax payers out rightly dodge tax payments. This limits tax revenue realized by the government because evasion reduces the number of tax payers
- High level of tax avoidance. Many would be tax payers use the loopholes in the tax laws to avoid tax payment. This is done by substituting taxed activities by untaxed ones or by declaring imported manufactured goods as intermediate products to be used in the production process thereby avoiding payments of taxes
- Small industrial sector, that is, low rate of industrial development. The industrial sector is mainly composed of small scale industries whose contribution to tax revenue is minimal
- Use of tax exemptions/concession in form of incentives to lure private investors and waivers for political reasons. Government grants tax concessions to foreign investors to attract them to invest in Uganda. Tax relief is at times given to people living in war ravaged areas because they are assumed to have no incomes for paying taxes
- Low taxable capacity/general poverty situation. Many people have extremely low income that cannot be subject to taxation while others due to their low incomes cannot pay heavy taxes resulting in low tax revenue collected
- Corruption by tax officials/corrupt officials. Tax officials embezzle revenues collected through taxation resulting in low revenues for the government
- High cost of collecting and administration of tax. Collection of taxes, especially incomes taxes is very expensive because it involves the use of many officials to coerce reluctant tax payers to pay the taxes
- Limited data or information on people's incomes/wealth. Many people receive incomes from various sources. These sources of incomes are not wholly known to the tax authorities because income earners conceal information about their incomes to avoid tax liabilities. This results in low revenue realized
- Large informal sector which is hard to follow up as people frequently change employment and are constantly being harassed by the local authorities like KCCA for failure to get permanent areas of operation. This results in low tax revenue realized
- Political unrest. Political instability scares tax collectors from collecting taxes from areas experiencing instability due to fear for their lives. This results in low tax revenue raised
- Poor tax administration/limited skilled tax administrators which results in tax payers' resentment hence low compliance rate. Most tax officials are not properly trained on how to collect revenue without use of brutal means. This makes tax payers to have tax payments instead of paying the taxes
- Poor infrastructure and limited facilities. Infrastructure in some parts of Uganda is very poor. Tax administrators also have limited facilities especially means of transport. This limits their accessibility to tax payers' thus low revenue collected
- Low tax rates imposed on tax payers. Although incomes are generally low, many tax payers pay less tax than they are capable of doing. A case in point is an minister paying the same amount of tax as a school teach despite the formers income being much higher

WAYS OF IMPROVING TAX COLLECTION IN UGANDA

- Reducing or eliminating corruption. Corruption by the tax authority should be controlled by prosecuting corruption tax officials and dismissing them from services in public interest. This may deter others from stealing tax revenue thereby increasing revenue collected
- Sensitizing or educating the masses on benefits of paying taxes. The masses evade tax payments because they do not know the good use to which tax revenue is put. When the masses are sensitized on the good use to which the revenue is being put, they may willingly start paying the taxes thereby increasing the amount collected and reducing the cost of collection
- Developing a tax payer friendly system of collection. There is need to develop a tax payer friendly system/method of tax collection other than goading defaulters, confiscating property of defaulters and locking up shops. All these actions waste productive time that would have been used for raising incomes for tax payments
- Adopting the principle of fairness in tax assessment. Taxes, especially direct taxes are unfairly assessed. The rich pay less than their taxable capacities due to poor assessment. The poor are sometimes over assessed and they end up evading tax payment. By improving assessment, the authority would be able to raise more revenue from the rich who can pay more and from the poor who would not evade payment because of unfair assessment
- Training up personnel to assess and collect taxes. Many tax officials do not have the skills required to assess and collect taxes from tax payers. There is need to train tax officials to provide them with adequate skills for tax collection where necessary, skilled foreigners can be also be employed to help in tax collection where skilled people are not locally available.
- Improving infrastructure. Infrastructures should be rehabilitated and new ones constructed to increase accessibility to tax payers especially in the rural areas by the tax collectors. This will improve tax collection in Uganda
- Ensuring political stability. Political stability should be ensured not only to ensure stable production activities but also to ensure safety of tax collectors in moving to all parts of the country to collect taxes
- Ensuring proper and effective use of tax revenues. Tax revenues ought to the put to uses that the tax payer can see as being beneficial to him or the community as a whole to reduce resistance to tax payment by tax payers. This can be done by the government providing essential goods and services which are beneficial to society as a whole. It can also be done by involving the local people in deciding the use to which tax revenue can be used. Lastly part of the revenue should be returned to the local areas for the development of the areas from which the tax revenue was collected
- Ensuring proper/improved implementation of tax laws. Tax laws ought in be implemented so as to prevent malpractices such as smuggling, falsification of finished products as raw materials or intermediate products to be used for further production to evade and avoid tax payments. This too will lead to increased collection of tax revenue in Uganda

MEASURES TAKEN TO INCREASE REVENUE IN UGANDA – A SUMMARY

- Revamped or reorganized Uganda revenue authority (URA) to reduce corruption in the tax collecting body
- Sensitized the public/tax payers about in the importance/benefits of paying taxes, this move increases the level of tax compliance and thus tax returns
- Developed a more tax payer friendly system. This increases tax compliance
- Higher level of implementation/enforcement of tax laws
- Concentrated more on indirect taxes which are more yielding that direct taxes
- Improved political atmosphere
- Encouraged growth of industrial and tertiary sectors

- Controlled level of tax evasion
- Improved on tax administration so that it is pro-people
- Made efforts to widen the tax base
- Worked on loopholes in tax laws to reduce tax avoidance
- Controlled costs of tax collection through improving the system especially use of high technology in collection
- Ensured effective use of taxes to improve on attitude of population
- Expanded infrastructure to make places accessible

THE NATIONAL BUDGET/GOVERNMENT BUDGET

A government budget is an estimate of revenue the government expects to raise and how it plans to spend the revenue during a financial year

Or

It is a statement of government estimated income and estimated expenditure during the financial year

Or

Is an estimate of a country's expected revenue and anticipated expenditure for a given fiscal year

OBJECTIVES/AIMS/PURPOSE/ OF A NATIONAL BUDGET

The objectives of a national budget in my country include

- To control inflation (attaining and maintaining price stability). The budget is used to control inflation and maintain price stability. During periods of inflation, the budget through tools of taxation can be used to reduce disposable incomes by taxing incomes to reduce aggregate demand and minimize price rise
- To reduce income inequality. The budget aims at reducing income inequality by using PAYE which involves taxing the rich more heavily than the poor
- To reduce unemployment. The budget aims at creation of employment opportunities through increasing government expenditure in the establishment of public sector projects to create employment
- To improve balance of payments position. The budget aims at attaining balance of payment equilibrium by measures such as increasing tariffs on non-essential imports to discourage their importation, waiving taxes on exports to increase on the volume of exports, increase export earnings and solve balance of payments problems
- To protect infant (domestic) industries. The budget aims at protection of (domestic) industries through imposition of tariff and non-tariff barriers on substitute imports to make them less competitive at home than the locally produced goods
- To raise revenue for the government. The budget aims at raising revenue (public income) for government through various fiscal measures such as taxation, borrowing, licensing among others which can help in recurrent and development expenditure
- To mobilize (solicit) foreign resources. the budget aims at enabling the government to solicit foreign aid by indicating shortfalls in domestic revenue necessitating sourcing of foreign resources to fill the tap. It also indicates to the donors how government plans to utilize the foreign resources when acquired thus acting as inducement to them to help
- To discourage consumption of undesirable products. The budget aims at discouraging the consumption of demerit goods through taxing them heavily and making them less affordable to consumers so as to protect consumers' health
- To promote economic growth. The budget aims at accelerating the rate of economic growth by increasing the level of resource utilization. Provision of finance and foreign exchange, tax holidays, developmental rebates, subsidies and soft loans can be given to investors to encourage resource

utilization and to contribute to growth of investment in the private sector of the economy to increase output and economic growth

- To reduce regional imbalances in trade and development. The budget aims at reducing regional inequality through the budget, more funds can be allocated through discretional fiscal policy to disadvantaged regions than to developed ones to enable the poor people participate in production and to uplift the incomes in the less developed regions
- To regulate investment or resource allocation. The budget aims at influencing and accelerating the rate of investment in the private and public sectors of the economy. This is achieved by using taxation whereby some forms of investment are discouraged while others are encouraged
- To reduce economic dependence. The budget aims at ensuring that the economy becomes self-reliant by encouraging potential investors to set up import substitution industries. This is achieved through provision of tax holidays and other inducements
- To mobile the masses to participate in the process of national development. The budget aims at mobilizing the local population to participate in government programmes aimed at developing local areas

INFORMATION CONTAINED IN A BUDGET

The following are items or some of the information that is contained (included) in a national budget

- Review of the previous financial year's social economic performance ie successes and failures of the country
- The current size of Gross Domestic Product (GDP) or Net Domestic Product (NDP) of a country
- The current economic growth rate of the economy
- The desired economic growth rate in the near future
- The balance of payments position
- The contribution to the national economy or GDP by each sector, that is, agriculture, industry, commercial, tourism, mining, consumption, transport among others
- The objectives of the current financial year's budget
- Total estimated revenue and expenditure for the next financial year
- The monetary and fiscal strategies for the year

CLASSFICATION OF BUDGETS

There are two main types of budgets namely; balanced and unbalanced budgets.

A balanced budget is one in which planned government expenditure is equal to planned government revenue during a given financial year

While

Unbalanced budget is one where the estimated government expenditure is either greater than the estimated government revenue (deficit budget) or the planned government revenue is greater/exceeds the estimated government expenditure (surplus budget) in a given financial year

Or

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

Thus, there is a surplus budget and a deficit budget

KEY DEFINITIONS

- ❖ Surplus budget (surplus national budget) is one in which the estimated/projected/planned government revenue exceeds the estimated/projected/planned expenditure in a given financial year (fiscal year)

- A deficit budget (deficit national budget) is one in which the estimated/projected/planned government expenditure exceeds the estimated/projected/planned revenue in a given financial year (fiscal year)

- Recurrent budget is the estimate of anticipated day to day revenue and expenditure of the state.

  Recurrent revenue consists of returns on government investment, sales of short term securities among others. If revenue exceeds expenditure, then the recurrent budget is a surplus

- Development budget on the other hand is concerned with anticipated government revenue and expenditure in the course of development

- Revenue for development budget may be from abroad in form of foreign aid or it may be from internal borrowing.

  The revenue collected is used for development projects and such development expenditure is largely concerned with increasing productive capacity for example building schools, roads and railways

BENEFITS OF A NATIONAL BUDGET

The benefits of a national budget in my country include

- Controls inflation. The budget helps to control inflation and maintain price stability. During periods of inflation, the budget through tools of taxation is used to reduce disposable incomes by taxing incomes to reduce aggregate demand and minimize price rise
- Reduces income inequality. The budget reduces income inequality by using PAYE which involves taking the rich more heavily than the poor
- Reduces unemployment. The budget helps in creation of employment opportunities through increasing government expenditure in the establishment of public sector projects to create employment
- Improves balance of payments position. The budget helps in attaining balance of payment equilibrium by measures such as increasing tariffs on non-essential imports to discourage their importation, waiving taxes on exports to increase on the volume of exports, increase export earnings and solve balance of payments problems
- Protects infant (domestic) industries. The budget protects domestic industries through imposition of tariff and non-tariff barriers on substitute imports to make them less competitive at home than the locally produced goods
- Raises revenue for the government. The budget raises revenue (public income) for government through various fiscal measures such as taxation, borrowing, licencing among others, which help in recurrent and development expenditure
- Mobilises (solicits for) foreign resources. the budget enables the government to solicit for foreign aid by indicating shortfalls in domestic revenue necessitating sourcing of foreign resources to fill the gap. It also indicates to the donor how government plans to utilize the foreign resources when acquired thus acting as inducement to them to help
- Discourages consumption of undesirable products. The budget discourages the consumption of demerit goods through taxing them heavily and making them less affordable to consumers so as to protect consumers' health
- Promotes economic growth. The budget accelerates the rate of economic growth by increasing the level of resource utilization. Incentives like tax holidays, tax rebates, subsides and soft loans are given to investors to encourage resource utilization and to contribute to growth of investment in the private sector of the economy so as to increase output and economic growth

- Reduces regional imbalances in trade and development. The budget reduces regional inequality. Through the budget, more funds are allocated through discretional fiscal policy to disadvantaged regions than to developed ones to enable the poor people participate in production and to uplift the incomes in the less developed regions
- Regulates investment or resource allocation. The budget influences and accelerates the rate of investment in the private and public sectors of the economy. This is achieved by using taxation whereby some forms of investment are discouraged while others are encouraged
- Reduces economic dependence. The budget ensures that the economy becomes self-reliant by encouraging potential investors to set up import substitution industries. This is achieved through provision of tax holidays and other inducements
- Mobilizes the masses to participate in the process of national development. The budget mobilizes the local population to participate in government programmes aimed at developing their areas

THE SIGNIFICANCE OF A GOVERNMENT BUDGET AS A TOOL OF SOCIO-ECONOMIC POLICY
- Raising revenue through taxation to finance government activities
- Maintaining economic stability through measures to control inflation
- Attaining balance of payments stability
- Creation of employment through stimulation of economic activities
- Attainment of economic growth through investment
- Reducing income inequality
- Protection of infant industries
- Mobilization of foreign resources
- Redistribution of resources from private to public sector
- Increasing aggregate demand

USES OF THE NATIONAL BUDGET
- Used to create employment opportunities
- Used to control inflation
- Used to accelerate the rate of economic growth
- Used to improve the balance of payments position
- Used to raise revenue for the government
- Used to discourage consumption of harmful goods
- Used to protect infant industries
- Used to specify sectors suitable for private and public investment
- Used to mobilize foreign resources, that is, to solicit for foreign aid
- Used to reduce economic dependence
- Used to reduce income inequalities

ROLE OF THE NATIONAL BUDGET IN ACHIEVING THE GOVERNMENT GOALS IN DEVELOPING COUNTRIES
- Creation of employment opportunities. The budget aids in creation of employment opportunities through increasing government expenditure in the establishment of public sector projects to create employment
- Attaining and maintaining price stability. The budget is used to control inflation and maintain price stability. During periods of inflation, the budget through tools of taxation is used to reduce disposable incomes by taxing incomes to reduce aggregate demand and minimize price rise
- Correction of balance of payments deficits. The budget ensures the attainment of balance of payment equilibrium by measures such as increasing tariffs on non-essential imports to discourage their

importation, waiving taxes on exports to increase on the volume of exports, increase export earnings and solve balance of payments problems

- Protection of infant industries/firms. The budget enables protection of (domestic) industries through imposition of tariff and non-tariff barriers on substitute imports to make them less competitive at home than the locally produced goods
- Reduce income inequality/promotion of equitable income distribution. The budget reduces income inequality by using PAYE which involves taxing the rich more heavily than the poor
- Discouraging consumption of harmful/demerit/undesirable products. The budget is used to discourage the consumption of demerit goods through taxing them heavily and making them less affordable to consumers so as to protect consumers' health
- Raise revenue for the government. The budget raise revenue (public income) for government through various fiscal measures such as taxation, borrowing, licencing among others, which can help in recurrent and development expenditure
- Accelerates the rate of economic growth. The budget is used to accelerate the rate of economic growth by increasing the level of resource utilization. Provision of finance and foreign exchange, tax holidays, developmental rebates, subsidies and soft loans can be given to investors to encourage resource utilization and to contribute to growth of investment in the private sector of the economy to increase output and economic growth
- Management of the public debt
- Influences investment/influences resource allocation. The budget influences and accelerates the rate of investment in the private and public sectors of the economy. This is achieved by using taxation whereby some forms of investment are discouraged while others are encouraged
- Used to create balance in regional development. The budget ensures reduction in regional inequality. Through the budget, more funds can be allocated through discretional fiscal policy to disadvantaged regions than to developed ones to enable the poor people participate in production and to uplift the incomes in the less developed regions
- Reduction of economic dependence. The budget ensures that the economy becomes self-reliant by encouraging potential investors to set up import substitution industries. This is achieved through provision of tax holidays and other inducements
- Mobilization of the masses. The budget when properly drawn mobilizes the local population to participate in government programmes aimed at developing their areas, thereby enlisting peoples' support
- Mobilization of foreign resources. the budget enables the government to solicit foreign aid by indicating shortfalls in domestic revenue necessitating sourcing of foreign resources to fill the gap. It also indicates to the donors how government plans to utilize the foreign resources when acquired thus acting as inducement to them to help

PROBLEMS ENCOUNTERED BY GOVERNMENTS OF DEVELOPING COUNTRIES WHEN DRAWING THEIR NATIONAL BUDGETS

- Limited data or information. Statistical data what are available are inaccurate and in some cases lacking due to poor record keeping. Statisticians have difficulty gathering accurate information and data for budget formulation leading to either under gathering or inaccurate estimation of resources necessary for successful budgeting
- Limited control of national phenomena leading to uncertainties especially in the agriculture sector. Due to unpredictability and limited control of natural factors, it is difficult to formulate realistic budgets for the agriculture sector. It is for example difficult to predict severe droughts or floods in future so that plans can be made to reduce their effects on production and other economic activities. Limited control of natural factors also makes it difficult to estimate accurately output of planned projects

- Limited skilled labour. Proper formulation of budgets requires highly skilled and experienced statisticians who are in short supply in developing countries due to poor training and insufficient motivation of labour. This results in poor budget formulation due to the inability of statisticians to identify correctly projects to undertake, timing of the projects as well as project costs
- Limited government commitment. Politicians lack commitment to the drawing of constructive budgets due to uncertainty of tenure in power, love for the informal patronage and lack of concern for practical solutions. They therefore, do not commit sufficient resources necessary for formulation of budgets
- Difficulty in identifying viable/worthwhile projects. It is difficult to identify viable projects due to business uncertainties in developing countries. Market conditions are ever changing. Changes in market conditions make projects that are viable today not viable tomorrow. Consequently, medium term and long term development projects are difficult to formulate in the national budget.
- Limited financial resources. government has insufficient financial resources to be used for data and information gathering, hire and retention of skilled statisticians and purchasing of facilities necessary for budget formulation
- External influence. Donors make budget formulation difficult by dictating conditionalities that recipient countries must meet, before funds for budget implementation can be released. They also dictate the projects and sectors to be budgeted/planned for even if the projects are not central to the country's development. This causes disagreements between donors and local planners over budget priorities hence delaying the process of budget formulation
- Corruption on the part of national budget formulators. Officials charged with budget formulation misuse (misappropriate) funds meant for the activity. This leaves insufficient funds for data gathering, purchase of facilities and hire of statisticians. Consequently, poor quality budgets are drawn

SURPLUS BUDGET

A surplus budget is one in which planned government revenue exceeds planned government expenditure during a given period of time

Objectives of a surplus budget

The government may plan for a surplus budget in order to achieve the following objectives

- To regulate a boom ie a period of much economic activity. Government increases taxes and reduces her expenditure in order to reduce a boom and avoid a boom from digressing into a recession. This is because increasing taxation and reducing government expenditure controls consumer's income and demand for consumer goods and services thereby maintaining economic stability.
- To reduce aggregate demand
- To reduce inflation by withdrawing money from circulation. Government applies a surplus budget by increasing direct taxes and reducing government expenditure on non-essential goods and services in order to reduce disposable incomes reduce aggregate demand and control inflation
- To accumulate funds for financing development projects or investments. Surplus budgets are planned in order to put aside some funds to finance future investment needs that require huge capital that can only be raised through periodic savings by surplus budgeting
- To accumulate reserves for future needs. Through surplus budgeting, funds are set aside and accumulated in the central bank and other banks both at home and abroad to be used in the future even for purposes that cannot be foreseen now

Disadvantages/Shortcomings/ of a surplus budget

- Reduces aggregate demand and may lead to an economic slump. Increasing taxes on incomes and reducing government expenditure reduces aggregate demand leading to surplus output due to lack of effective demand. Consequently, firms reduce output and may lead to decrease in gross domestic product and in economic slump

- Creates unemployment. Increasing income taxes and reducing government expenditure reduces aggregate demand which cuases producers to cut output to lower production costs hence unemployment
- Low rate of economic growth due to decline in economic activities. Surplus budgeting involves increasing income taxes and reducing government expenditure. Aggregate demand falls and producers reduce output leading to a fall in economic growth rate
- Reduced welfare due to reduced consumption. Peoples' standards of living fall as a result of increasing taxes on incomes that reduces disposable incomes and aggregate demand. Consumers' welfare also falls when government reduces expenditure on provision of basic consumer goods and services thereby forcing the poor to do without basic goods

Deficit budget; is one where the government planned expenditure is greater than the government planned revenue in a given fiscal year

OBJECTIVES/REASONS FOR A DEFICIT BUDGET

- To raise aggregate demand and stimulate the economy
- To leave enough disposable income with the public to encourage development
- To encourage savings and investment by not taxing peoples' incomes
- To avoid negative/adverse effects of taxation
- To uplift/offset the economy by closing the deflationary gap
- To allow firms plough back their profits instead of taxing their surplus revenue/incomes
- To avoid taxing peoples' incomes/wealth since borrowing is easier
- To solicit/earn political support

CAUSES OF THE PERSISTENT BUDGET DEFICITS IN UGANDA

An account for the persistent budget deficits in my country

N.B Let the student bring out the rising government expenditure as opposed to low of falling government revenue

- Rising/high costs of infrastructural development. Most developing countries face rising costs of providing infrastructure such as schools, hospitals, construction of railway lines, funding of power projects and rehabilitation of roads in order to meet the needs of both the growing population and economic growth projections. The costs of providing these infrastructures by far surpasses government revenue thus deficit budgets
- Frequency of natural disasters/hazards that require heavy emergency funding. Most developing countries experience natural hazards such as the landslides in Bududa are in Bududa district and floods that affected Teso region in 2010, which cause a lot of destruction and human suffering thus requiring substantial emergency relief funds to solve the negative effects. These expenditures are usually not planned for because their occurrence cannot be anticipated and therefore cannot be met out of tax revenue thus causing revenue to fall short of planned expenditure
- High levels of corruption/embezzlement of public funds (ie low levels of accountability). Government officials are too corrupt and do not only swindle government revenue at the time of collection, but over budget for government expenditure beyond what is required for project implementation. this results in planned expenditure surpassing planned government revenue
- Limited non-tax sources of revenue/low revenue from non-tax sources. Very limited revenue is raised from non-tax sources such as fines, fees, profits and special assessments. This results in failure by the revenue authority to top up tax revenue to meet government expenditure needs hence budget deficits

- Heavy expenditure on defence due to political instability. Developing countries face political instabilities due to constant armed rebellions. This calls for increased defence expenditure in the acquisition of sophisticated military hardware and financing military programmes which cannot be met out of tax revenue hence deficit budgeting
- Heavy expenditure on civil servants and politicians. Government has a large number of public sector workers such as politicians, teachers, medical workers and district officials who require large wage bills. The large wage bill cannot easily be met out of tax revenue hence the need for borrowing to pay wages
- Overambitious planning. Government involvement in ambitious projects such as construction of airports, complex sports stadia, electric power generation, mineral exploration and establishment or iron and steel mills. These projects are usually too expensive to be met by the Tax revenue hence deficit budgets
- Persistent/heavy debt servicing and repayment of principal. Developing countries borrow both internally and externally. Since most of the funds acquired from borrowing are not used for productive purposes, they cannot generate revenue for self-liquidation. This calls for further borrowing to survive and service the debts since amounts to be borrowed are always in excess of tax revenue
- Narrow/few tax bases. There are few economic activities, due to low levels of diversification and industrialization, on which taxes can be imposed. This results in low tax revenue realized by government yet government has numerous expenditure needs hence budgetary deficits in developing countries
- Low taxable capacity. People in developing countries have low taxable capacity due to low incomes, a large number of dependants and high cost of living. Therefore, heavy taxes cannot be imposed on them to raise enough revenue to meet government expenditure needs
- Heavy expenditure on external commitments. Developing countries are required to make contributions to international organizations and regional co-operations to which they are members such as money contributed to international organizations like UNO, African Union, IMF and peace keeping mission in Somalia (AMISON). The contributions are not only many but times accumulate and become too large to be met out of planned revenue hence budgetary deficits
- Weak tax administration. The system of tax administration is weak due to employment of unskilled tax officials who do not have sufficient knowledge and facilities to collect revenue effectively. This leads to low tax revenue realized amidst rising government expenditure thus budgetary deficits

(a) Distinguish between a surplus budge and deficit budget

A surplus national budget is one in which the estimated/projected/planned government revenue exceeds the estimated/projected/planned expenditure in a given financial year (fiscal year)

Whereas

A deficit national budget is one in which the estimated/projected/planned government expenditure exceeds the estimated/projected/planned government revenue in a given financial or fiscal year

(b) Explain the causes of the persistent budget deficits in your country.

N.B Let the student bring out the rising government expenditure as opposed to low of falling government revenue

- ➢ Rising/high costs of infrastructural development
- ➢ Frequency of natural disasters/hazards that require heavy emergency funding
- ➢ High levels of corruption/embezzlement of public funds/low levels of accountability. (government officials inflate government spending) political instability that leads to high military expenditure and low government revenue
- ➢ Limited non-tax sources of revenue/low revenue from non-tax sources

- Heavy expenditure on civil servants and politicians – this focuses on administrative expenditure of government
- Heavy debt servicing and repayment of the principal, this focuses on expenditure related to payment of external debts
- Heavy expenditure on external commitment
- Ambitious planning by the government ie this creates excessive spending on such projects yet revenue to government is low
- Few tax bases/a narrow tax base
- Weak tax administration/tax evasion and avoidance
- Low taxable capacity

MEASURES WHICH CAN BE TAKEN TO REDUCE BUDGETARY DEFICITS IN UGANDA

Measures that should be taken to minimize the persistent budgetary deficits in my country include;

- Undertake cost sharing in the provision of basic services. Cost sharing between government and users should be introduced in the provision of basic goods and services such as education and health so as to reduce government expenditure used in the provision of the goods free of charge
- Political stabilization measures. Measures aimed at stabilization of politics through for example, negotiations with rebels should be undertaken so as to ensure peace and stability in the country and reduce government expenditure on defence
- Restructure and rationalize foreign missions. Foreign missions be structured by closing some and merging others as well as recalling some of the personnel in diplomatic missions abroad to reduce government expenditure on diplomacy
- Privatization of (non-essential) state enterprises or assets. There should be continued sale of non-performing government enterprises to private individuals so as to reduce government expenditure on subsides to public enterprises
- Retrenchment. Non-essential workers should be retrenched to reduce the size of the public service, reduce the wage bill and move towards balancing the budget
- Avoid or reduction in the acquisition of unproductive debts. Efforts should be made to avoid acquiring debts for unproductive purposes such as war loans and for temporary stabilization of the balance of payments disequilibrium. This reduces pressure to look for revenue from elsewhere for debt repayment since dead weight debts are not self-liquidating thus cause of budget deficits
- Undertake systematic planning. There should be systematic planning to avoid waste of resources on undesirable projects or on projects that cannot be completed so as to avoid unnecessary government expenditure that leads to budgetary deficits
- Fight corruption. Measures should be taken to reduce wastes of government resources through embezzlement by strengthening integrity laws, strengthening the office of the OMBUDSMAN, the public accounts committee and other institutions charged with fighting corruption
- Increase non tax sources of revenue to government other than borrowing. Non-tax sources of revenue such as licenses, rates, fees, rent, profits road tolls, special assessments and market dues should be increased so as to increase government revenue and reduce budgetary deficits
- Control population growth rates. Population control measures like family planning programmes should be promoted to reduce expenditure on the provision of social services such as schools, hospitals and other infrastructures
- Decentralization of power. Power should be decentralized from the central government to the local government to reduce dependence of the whole country on the centre for resources which leads to increase in government expenditure. Decentralization also reduces pressure for resources from the centre by the local authorities because it enables the local authorities to look for resources from their areas for subsistence

- Increase tax revenue. Tax revenue can be increased through identification of more tax bases on which taxes can be levied, diversification of the economy to increase tax bases, strengthening tax administration through training of tax officials to improve collection and fighting tax avoidance and tax evasion

DEFICIT FINANCING
Deficit financing is a deliberate government measure aimed at reducing the level of government revenue by reducing taxation while maintaining or increasing government levels of expenditure.
Or
Deficit financing is a planned government budget in which planned expenditure is in excess of revenue.

It is undertaken in order to increase aggregate demand and stimulate economic activities

Sources of financing during a period of deficit budget
The sources of finance to government during periods of deficit finance include;
- Public borrowing both internally and externally
- Depleting accumulated reserves
- Using forced savings such as funds with social security fund and insurance companies
- Grants from friendly governments and enterprises to provide public goods

Objectives of deficit financing
The following are the objectives of deficit financing
- To pull an economy out of a slump or recession or depression, thus aiding economic recovery. Government reduces taxation but increases her expenditure largely out of borrowed funds in order to buy off surplus products and create buffer stocks and aid economic recovery from a slump
- To reduce taxes to increase peoples purchasing power. A deficit budget is aimed at reducing taxation while increasing government expenditure in order to increase aggregate demand, encourage investment, output and economic growth
- To create employment opportunities. Deficit budgeting facilitates creation of employment opportunities when taxes are reduced, disposable incomes and aggregate demand are increased thereby increasing investment activities which create new employment opportunities
- To raise large sums of money quickly. Government employs deficit financing so as to raise large sums of revenue quickly, both internally and externally because taxation is always a slower method of raising revenue. Moreover, revenue from taxation at times is not so certain
- To minimize the burden of taxation on the taxpayers. Taxable capacity in developing countries is very low and therefore, government finds it difficult to raise sufficient revenue through taxation without overstraining her citizens. Thus it prefers borrowing to taxing as a means of raising revenue hence budgetary deficits
- To maintain or even increase political acceptability. Increasing revenue through increasing taxes is politically unpopular in developing countries. Deficit financing is therefore, aimed at maintaining government's political popularity

Disadvantages/Demerits/Shortcomings of deficit financing
- Tends to be inflationary. Deficit financing may be inflationary when increase in aggregate demand as a result of increased government expenditure and reduced taxation is not countered by increased output and supply of essential goods and services
- Balance of payments problems. Government borrowing from abroad escalates balance of payments problems when the funds are not used tor investments either to produce goods to increase export

capacity nor to produce goods to reduce dependence on imports but for financing unproductive activities such as war
- Creates dependence on external resources. when the government perpetually fails to raise adequate revenue through taxation and other sources and seeks external aid in order to acquire resources in order to meet both her recurrent and development expenditure
- Government my fail to finance development projects due to failure to secure loans or grants in time

PUBLIC DEBTS
A public debt refers to the total borrowing by the state, local authorities and public corporations

By public debts it is meant borrowing by the government from within the country or from government from private individual, associations or banking and non-banking financial institutions
Public debts comprise borrowing by central government, local authorities and public corporations (parasite)
National debts (or public debts proper), is debt owned by government to people and institutions within its own borders (internal debts) or to foreign creditors (external debts)

CLASSIFICATION OF DEBTS
Public debts can be classified into
1. Internal/external debts
2. Reproductive/non reproductive (or unproductive)
3. Short term debts and long term debts

INTERNAL AND EXTERNAL DEBTS
Internal (domestic) debts are borrowings from people and institutions within the country by the government and includes sales of treasury bills, stock, bonds etc
Or
A domestic debt is the money owned by the central government to domestic entities such as the public, commercial banks etc

Sources of an internal debt
- Sale of treasury bills
- Compulsory saving schemes (NSSF)
- Sale of government stocks, shares in companies and securities
- Purchase of tax reserve certificates

While

An external debt is the money owned by the central government to foreign governments and international agencies
Or
External debts are borrowings by a government from abroad. The loans could be from, for example, the international monetary fund (IMF) and world bank (IBRD) or private organizations

REPRODUCTIVE DEBTS AND UNREPRODUCTIVE DEBTS

A reproductive debt or productive debt is one which is used to finance projects that bring in returns for example used to purchase industrial inputs, real assets etc

Or
It is a debt which is self-liquidating
Or
Refers to one which is obtained for the purchase of real assets which generate income for the repayment of the debt
While
A dead weight debt is that which is used to cover unproductive expenditure for example buying fire arms
Or
A debt that is not self-liquidating
Or
Refers to one with no corresponding assets, for example, a debt incurred to fund a war or balance of payments (BOP) deficits. The interest on the principle and the repayment of the principle has to be paid from taxes and other sources of public revenue

SHORT TERM (FLOATING) AND LONG TERM (FUNDED) DEBTS
Short term (floating) debt refers to one which is repayable after a short period of time (less than a year) usually in form of treasury bills and ways and means. Such debts are supposed to bridge the gap between current revenue and current expenditure
While
Long-term (funded) debt is a long term public debt that has no specific date of redemption
Or
Is a public debt where the date/time for repayment is not stated or specified, for example, medium and long term loans from the world bank (IBRD)

PURPOSE/NEED FOR PUBLIC DEBT
REASONS AS TO WHY DEVELOPING COUNTRIES INCUR PUBLIC DEBTS
(REASONS WHY THE GOVERNMENT MAY BORROW)

Government borrows both internally and externally for the following reasons
- To ease the burden of taxation on citizens in the short run. In the absence of borrowing, government would have to tax people more heavily in order to realize the desired revenue thereby leading to heavier tax burdens on the tax payers. Heavy tax burdens may cost government its popularity as voters blame it for being extravagant and extortionate
- To fill the foreign exchange gap resulting from low incomes from exports and high expenditure on imports. The borrowed foreign exchange helps the countries borrowing to import the much needed essential consumer goods and services so as to help finance the balance of payments deficit in the short run
- To raise funds currently needed for recurrent public expenditure (need to fill government revenue-expenditure gap); Government borrows due to need to fill the government revenue-expenditure gap. Tax revenue usually falls short of anticipated government expenditure. Government therefore, borrows in order to finance recurrent and capital investment expenditure that cannot be met from tax revenue
- To supplement tax revenue; tax revenue usually fall short of anticipated government expenditure. Government therefore, borrows in order to finance recurrent and development expenditure that cannot be met from tax revenue
- To fill the savings-investment gap. Developing countries borrow resources to finance their development plans that cannot be funded by the low domestic savings. They, therefore, borrow not only from within the country but also from foreign sources to generate funds for investment in the development of industry, mining agriculture, power, transport and communication

- To sustain market by leaving citizens with adequate disposable incomes. Borrowing is aimed at ensuring that the citizens are left with enough disposable income to maintain a given level of welfare
- To handle the effects of calamites or disasters. Natural calamities like floods, earthquakes and famine increase government expenditure in order to provide relive of victims. This necessitates urgent and substantial funding which developing countries lack hence need for borrowing
- To fill the manpower gap. Foreign borrowing in most cases contains manpower packages. This helps to fill the skilled manpower gap which developing countries have due to poor education systems which create inadequate supply of skilled labour
- To help the country borrowing achieve and maintain a given level of employment. Borrowed funds are injected in productive ventures so as to create employment opportunities for the citizens
- To control inflation by reducing the amount of money in people's hands in case of selling securities. Borrowing is a tool of controlling inflation. When government borrows internally it takes away excess money supply from the public thereby aggregate demand and reducing inflation
- To help repay interest and eventually the principal sum borrowed. The pressure of debt servicing often leads to borrowing. The developing countries are heavily indebted due to incurring of dead weight debts which are not self-liquidating. This causes the need to acquire loans with lower interest rates in order to clear debts with higher interest rates
- To raise large sums of money quickly. Borrowing is a quicker and more assured source of raising a large sum of money. Taxation takes a long time before the required amount of revenue is raised and sometimes the amount to be raised is uncertain, therefore, government borrows in order to raise large sums of money promptly
- To improve relations between countries. Borrowing creates a favourable attitude of the recipient country towards the creditor nation. This improves relations between countries and results in increased flow of trade between them

CAUSES OF THE HIGH PUBLIC DEBT IN UGANDA

- High level of calamities
- High infrastructural development
- High levels of borrowing to service the foreign debts
- High military expenditure to control political instabilities
- Low tax base
- Low taxable capacity
- High level of corruption
- High government expenditure on a large public sector
- Persistent inflation
- High tax evasion and avoidance
- High population growth rate
- Over ambitious government plans
- International commitments/engagements

ADVANTAGES ASSOCIATED WITH BORROWING

Merits of borrowing

- Supplements government revenue
- Fills the manpower gap
- Fills the technological gap
- Reduces negative effects of taxation on consumption, savings, and investment
- Fills the foreign exchange gap
- Internal borrowing helps to control inflation
- Enables the government to alleviate the effects of natural disasters

- It is a fast means of raising large amounts quickly
- It is convenient because debt repayment can be rescheduled

DISADVANTAGES ASSOCIATED WITH BORROWING

Demerits of borrowing include

- Encourages external resource dependence
- Promotes foreign exchange (forex) outflow hence worsening balance of payments position
- Leads to increased debt repayment which undermines capital formation at home
- Worsens income inequality
- Promotes foreign economic and political domination
- Leads to manipulation of the country by foreigners for example IMF conditionality, that is , it is sometimes associated with strings (conditionalities) which are disastrous
- Increases external debt repayment obligations which limit import capacity
- Promotes resource misallocation through corruption and extravagance
- Citizens are burdened by taxes in order to realize revenue to pay debts
- External borrowing may be inflationary
- Shifts the burden of repayment to the future generation which may not have gained from the debt

REASONS WHY GOVERNMENT MAY RELY MORE OR DEBT FINANCING (BORROWING) THAN TAXATION FINANCING

- Debt financing does not have negative political effects like resentment of the government of the day compared to taxation financing which is burdensome and arouses resentment of the day's regime
- Borrowing is a convenient method of raising revenue for government because it is the easiest way of raising revenue than taxation
- Debt financing helps to realize a lump sum of money compared to taxation which is slow in bringing in money
- 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 effects on consumption compared to taxation that reduces the disposable income of the people
- Debt financing does not involve costly methods of collection compared to taxation
- Debt financing does not discourage production by increasing the cost of production unlike taxation which increases the cost of production
- Debt financing does not discourage savings and investment compared to taxation
- Debt financing increases foreign reserves of the country and encourages foreign investment compared to taxation which discourages potential foreign investors
- The burden of borrowing can be postponed to the future generation than taxation who burden is felt by the present generation
- Borrowing can be used to fight inflation, especially, internal borrowing which reduces the volume of money in circulation through sale of securities to the public compared to taxation which causes cost push inflation
- Borrowing is a quicker method of raising money than taxation

NATIONAL DEBT

A national debt refers to the total borrowing both internal and external by the central government and public corporations excluding local authorities

Or

National debt refers to money owed by the state to its people and institutions within its borders or to foreigners, excluding debts of local authorities and public corporations

CAUSES OF A NATIONAL DEBT

- To supplement tax revenue (limited revenue from taxation)
- Need to fill the savings-investment gap
- Need to fill the foreign exchange gap
- To improve the terms of trade
- Natural calamities
- The pressure of debt servicing
- Used as a tool of monetary policy to draw money from circulation
- To fill the manpower gap
- To avoid adverse effects of taxation
- To finance ambitious development plans
- Borrowing is convenient because payment of the debt can be reschedule, quicker and raises more funds

What are the causes of a national debt?

BURDEN OF PUBLIC DEBT

Public debt is required to be paid back along with interest to an entity from which government borrowed.
The burden of a public debt is the hardship citizens of a debtor nation incur in order to repay a debt
It is also defined as the negative effect on the community of a national debt

The burden of a public (national) debt depends on the nature of this debt. For instance the burden of an external debt is usually greater than that of an internal debt

Ways of expressing the burden of a public debt
How does an economist express the burden of a public debt?
Internal debt

- Debt as a percentage of Gross National Product (GNP) or national income or Gross Domestic Product (GDP)

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

  The higher the percentage, the higher the burden and the lower the percentage the lower the burden

- Debt per person/debt per capita, that is, debt as a percentage of the total population of the country

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

  The higher the percentage, the higher the burden and the lower the percentage the lower the burden

- Debt per tax payer, that is, debt as a percentage of government revenue from taxation

  $$\frac{\text{Public debt} \times 100}{\text{Total tax revenue}}$$

  The higher the percentage, the higher the burden and the lower the percentage the lower the burden

- Debt per employed labour; that is, debt as a percentage of the total labourforce of the country

  Public debt x 100

Total labour force

The higher the percentage, the higher the burden and the lower the percentage the lower the burden

External debt

- Debt as a percentage of foreign exchange earnings

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

The higher the percentage, the higher the burden and the lower the percentage the lower the burden

- The rate of interest on borrowed funds. The higher the rate of interest, the higher the burden and the lower the rate of interest, the lower the burden
- Repayment period. The longer the repayment period, the lower the burden and the shorter the repayment period, the higher the burden

INTERNAL BORROWING

Tools of government internal borrowing

Tools of government internal borrowing are instruments used by government to acquire loans from institutions and individuals at home. They include

- Sale of government treasury bills and other securities. Government sells her securities such as treasure bills, bonds and consols to members of the public and the revenue realized is used for financing government activities
- Sales of bills on tap. These bills are sold to government departments with excess liquidity and revenue used to run activities of departments with shortages. They are offered at lower interest rates than bills on tender which are offered to the public
- Ways of means advances. Loans of extremely brief periods of time, say two to three days obtained from the central bank

Merits of internal borrowing

- Leads to public capital formation from which all gain
- Future generation benefits from public capital investments
- Public finance to subsidise the poor checks income inequality
- Controls inflation. Internal borrowing reduces money in circulation thereby controlling inflation
- Pulls an economy out of a depression. Borrowing from the central bank to increase government expenditure pulls an economy out of an economic depression
- Minimizes external dependence. Internal borrowing reduces external dependence because borrowing and repayment are transfers from one pocket to another but in the same jacket

Demerits of internal borrowing

- Discourages private capital formation. This is due to increase in taxation in order to raise revenue out of which interest and principal are paid, thereby reducing the levels of savings and investment yet the debt may have been used for unproductive purposes
- Increases income gap due to payment of high interest rate on debts to the rich that lent to government
- Taxes paid to raise money for debt payment reduce private consumption
- Loans to finance unproductive activities that are acquired from the central bank are inflationary
- It is a burden to the future generation who may not have benefited from the debt

EXTERNAL BORROWING

Merits of external borrowing

- Creates employment opportunities
- May increase the export capacity of a country
- Aids capital formation at the early stages of economic development, that is, fills the saving-investment gap
- Fills the technological gap in developing countries
- Supplements government tax revenue
- Fills the skilled manpower gap in developing countries
- Finances emergencies

Demerits of external borrowing (problems associated with an external debt)
- It is inflationary
- It is a burden to current and future generations
- Creates dependence of a country of increases laziness
- Encourages extravagancy
- Causes balance of payments problems
- High costs of administration
- Causes problems of debt servicing

WAYS OF CLEARING AN EXTERNAL PUBLIC DEBT
- Debt conversion
- Creation and use of a sinking fund
- Use of a surplus budget
- Negotiating for debt cancelling
- Utilizing grants and donations/gifts
- Use of foreign reserves
- Disinvestment/sale of investments at home and abroad

METHODS USED TO REDUCE BURDEN OF PUBLIC DEBTS IN UGANDA
- Debt rescheduling
- Negotiating for debt cancellation
- Debt conversion/borrowing from cheaper sources
- Grants
- Use of foreign exchange reserves
- Sale of gold reserves
- Sale of public investment in foreign countries
- Borrowing through sale of treasury bills and bonds through the central bank
- Controlled government expenditure

IN WHICH WAYS DO GOVERNMENTS PAY BACK PUBLIC DEBTS?

Internal debts
- Raising revenue by levying taxes
- Use of accumulated profits from state enterprises
- Sale of government securities
- Borrowing from internal and external sources
- Use of a sinking fund
- Operation of a surplus budget
- Financial accommodation/printing more money

External debt

- Disinvestment
- Negotiating for debt cancellation/relief/waiver
- Use of accumulated foreign reserves
- Use of grants/donations/gifts
- Encouraging export promotion
- Debt repudiation
- Debt rescheduling
- Debt conversion

DEBT REPAYMENT (REDEMPTION/SERVICING)

The government of a country can pay/redeem debts by

- Raising revenue by levying taxes
- Use of accumulated profits from state enterprises
- Sale of government securities like bond and treasure bills
- Borrowing from internal and external sources
- Use of a sinking fund. The government can create a fund for the repayment of debt. The government deposits a fixed sum of money out of its revenues each year for the period of the loan. After the end of period, the entire loan is paid back
- Disinvestment. This involves using surplus revenue realized from selling government assets especially parastatals; that is, disinvestment proceeds from parastatals help in debt redemption
- Operation of a surplus budget. The government pays the debt out of its revenue through a surplus budget. It makes a provision in the budget as to the amount to be paid during the year
- Debt repudiation. This is an outright denial of a debt. A government can refuse to honour in indebtedness of a debt and therefore refuse to pay it
- Debt rescheduling. This involves a request for postponement of the retirement date of a public debt
- Debt conversion, the government can get a new loan at low rate of interest and this loan can be used to repay any previous loan carrying high rate of interest even before it matures. This method helps in reducing the burden of interest
- Financial accommodation/printing more money. This involves asking the central bank to print more money to finance government programmes
- Negotiating for debt cancellation/relief/waiver. This involves asking debt forgiveness
- Use of accumulated foreign reserves like foreign currencies and gold
- Use of grants/donations/gifts; when government gets grants from another government/an institute, this amount can be used to repay debt
- Use of a capital levy; this is a special tax which is imposed by government on capital assets (of the very rich) to repay the national/public debt
- Debt swap. This means exchanging a debt for a debt. For example, if country P owes country Q and country Q owes country R, country R owes country P, the countries' indebtedness can be settled by having their liabilities with one another exchanged
- Use of terminal annuities. These are fixed sums payable for a fixed number of years

NB. An annuity is a sum of money received annually in one or more installments, for a period of time

Reasons why it is difficult to borrow in developing countries

- High interest rates in case of external loans
- Poor investment climate making it difficult for the public to lend money to the government
- High rate of illiteracy for example ignorance about government securities

- Weak and poor publicity of government securities
- High preference by the public to invest in real estates like houses which given social prestige hence discouraging investment in government securities
- Lack of organized capital and money markets that are necessary to mobilize savings in the rural areas
- High rates of inflation result in low response of the public to floated securities
- Instability of government and regimes making it difficult for the public to lend money to the government

Account for the persistent indebtedness of the developing countries
- The need to ease the burden of taxation on citizens
- The need to raise funds for government/limited revenue from taxes
- The need to fight persistent inflation in developing countries
- The need to help alleviate effects of calamites/existence of natural disasters
- Low domestic savings hence need to fill the savings-investment gap
- To fill the foreign exchange gap/to correct BOP deficits in the short run
- To fill the technological gap
- The need to fill the skilled manpower gap due to limited local skills
- The need to solve the unemployment problems
- The need to sustain market by leaving citizens with adequate disposable incomes
- Low levels of accountability leading to misuse of borrowed funds leading to inability of loans to self-liquidate
- Persistent dead weight borrowing leading to dead weight debts
- The need to attain high levels of economic growth leading to persistent borrowing
- The need to reduce negative effects of taxation on work effort and consumption
- The need to achieve political acceptance since borrowing is convenient

Explain the measures being taken to reduce the indebtedness of the developing countries
- Debt swap
- Debt repayment/payment of principal and interest on loans
- Appealing for debt relif/cancelling
- Debt repudiation
- Sinking fund
- Use of revenue from taxes
- Issuance of more currency/printing of more money
- Use of revenue from non-tax sources
- Operation of surplus budget/rationalizing government expenditure
- Disinvestment
- Borrowing from cheaper sources to pay the debt
- Debt rescheduling
- Debt conversion
- Appealing for grants and gifts
- Use of accumulated reserves/sale of good reserves
- Avoiding dead weight borrowing
- Ensuring proper use of loans to ensure self-liquidation of loans
- Internal borrowing through sale of government securities

Persistent debt burden in Uganda is due to the following reasons (UNEB 2018 P220/2 No 7)
❖ (High level of) corruption by government officials.

- ❖ Low tax revenue hence high debt to tax revenue ratio.
- ❖ High interest (rate) on loans.
- ❖ Low revenue from exports.
- ❖ Low gross domestic product/ national income.
- ❖ Continuous over- ambitious planning.
- ❖ High rate of inflation.
- ❖ Rising cost of public administration (for example exercising size of the …. Service).
- ❖ High debt servicing requirements.
- ❖ Rising government expenditure on programmes for employment creation, income generation, investment, etc.
- ❖ Rising costs of infrastructural development.
- ❖ Rising emergency funding due to frequency of natural hazards.
- ❖ Rising defense expenditure due to political unrest.
- ❖ High population growth rate hence increasing government expenditure on provision of social sciences.
- ❖ Rising government expenditure on external commitments/foreign missions

(b) **Methods being used to reduce the public debt in Uganda:**

- ❖ Fighting corruption.
- ❖ Stabilizing the political atmosphere.
- ❖ Debt conversion.
- ❖ Appealing for debt relief.
- ❖ Widening the tax base/ increasing tax rate.
- ❖ Encouraging exportation to increase foreign exchange earnings.
- ❖ Controlling the population growth rate.
- ❖ Using a sinking fund.
- ❖ Appealing for grants and gifts/ donations.
- ❖ Privatization/ disinvestment.

REVIEW QUESTIONS

(a) Distinguish between a reproductive debt and a dead weight debt

(b) Explain the methods of settling public debts in developing economies

PUBLIC DEBT MANAGEMENT

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

Objections of public debt management

- To maintain price stability
- To influence income distribution or to control income inequality
- To ensure proper utilization of funds/resources and reduce on corruption
- To reduce the debt burden so as to minimize the cost of the public debt
- To mobilise financial resources
- To influence the rate of interest

Methods of debt management

- Debt acquisition and management of interest rates to control the rate of borrowing
- Debt retirement/liquidation/redemption
- Debt swap

- Sinking fund
- Debt conversion
- Loan utilization
- Writing off the debt/concealment/debt relief
- Borrowing from cheaper sources to pay the debt

DEBIT SERVICING
This is the continuous and periodical payment of interest on public debts as a means of debt management

Adverse effects of debt servicing
- Increased balance of payments problem
- Reduces returns on domestic investments
- Increased external resource dependence
- Increased poverty of the nationals
- Bogs down capital formation
- Increased tax burden on nationals to service the debts

ROLE OF PUBLIC BORROWING IN LDCs
1. It is a sustained source or easy means of acquiring capital for accelerated development
2. Public debt bridges the low savings investment gaps that in most developing countries
3. It is a means of getting necessary foreign exchange and thus bridging the foreign exchange gaps
4. Borrowing supplements amount realized from taxation which in most LDCs have narrow base
5. It is a means of getting interests on idle money
6. Management of public debt can influence investment
7. Public debt can be used to accelerate the development of projects, particularly those which have slacked
8. Facilitate eradication of excess capacity that exists in many production units in LDCs

FISCAL POLICY
This is a deliberate policy under which government uses its expenditure and revenue (taxation) programmes to regulate the level of economic activities
Or
It is a deliberate effort by the government, regulate and control the level of economic activity through public revenue (taxation) and public expenditure programs to achieve desirable effects on production, distribution and employment level

OBJECTIVES OF FISCAL POLICY
- To raise employment level. Through increased government expenditure, government is able to create more employment opportunities by undertaking public investment in various projects
- To maintain fair distribution of national income/to reduce income inequality. Through fiscal policy, the government is able to reduce income inequality by taxing the rich more heavily than the poor and subsidization of the poor using the tax revenue
- To maintain economic stability/to control inflation/to ensure price stability. During inflationary periods, government is able to impose heavy taxes on incomes to reduce disposable incomes and aggregate demand and control demand pull inflation
- To increase the rate of economic growth. Taxation as a tool of fiscal policy is used to stimulate economic growth rate through provision of tax incentives such as tax holidays to investors to lower

production costs, increase profits, encourage investment, increase production hence economic growth

- To protect domestic infant industries. Heavy taxes are imposed on imports to make them relatively expensive than local products hence making local firms more competitive at home
- To discourage the consumption of demerit goods. Heavy taxes on demerit products to increase their prices, make them less affordable to consumers, discourage their consumption and protect consumers' health
- To promote investments. Through increased government expenditure on public investments and provision of tax holidays, there is an increase in the level of investment
- To improve the balance of payments position. Balance of payments is improved through imposing heavy taxes on imports to increase their prices and make the imports less affordable, discourage importation and reduce expenditure abroad
- To achieve the desirable political objectives. This is through providing tax incentives and reduction of direct taxes
- To achieve balanced regional development by taxing already developed areas and increase government expenditure in under developed areas
- To raise government revenue through taxation. Taxes are imposed on tax payers to raise revenue for the government to enable her meet her recurrent and development expenditure needs
- To control monopoly through heavy taxation of monopoly profits and subsidization of other firms
- To influence resource allocation through tax holidays/relief. Tax incentives are given to firms in socially desirable but less profitable activities to encourage the allocation of resources from the highly taxed to less taxed activities

Instruments of fiscal policy

Instruments of fiscal policy include

- Public (government) expenditure
- Taxation
- Public borrowing
- Subsidization
- Debt repayment
- Licensing
- Fees
- Fines

PUBLIC (GOVERNMENT) EXPENDITURE

This refers to the spending of government revenue by the central government and local authorities on the provision of services to the public.
Public expenditure may be categories into;

Recurrent expenditure (consumption expenditure or operating expenditure) is the day to day spending of government aimed at maintaining existing capacities.

for examples, payment of wages and salaries to civil servants, rates and rent, interest on national debts and periodic contributions to international organizations

Development expenditure (capital expenditure) is spending by government on capital goods/ investment/establishment of projects for purposes of expanding existing capacities and creating new ones to generate more goods and services.

Examples include expenditure on setting up hospitals/medical centres, schools, roads and other forms of infrastructure

CANONS OF PUBLIC EXPENDITURE

- Canon of benefit. Public expenditure should be incurred on various items that is provides maximum benefit to the society as a whole
- Canon of neutrality. Public expenditure should be incurred in such a manner that it neutralizes all adverse effects on production and distribution. It should encourage productive activity and at the same time reduce inequalities of income and wealth
- Canon of productivity. Public expenditure should help in increasing productivity. Public expenditure should increase such infrastructure facilities such as roads, bridges, railways, transport, communication and power
- Canon of equity. Public expenditure should be incurred in such a manner that it helps in reducing the inequalities of income and wealth. The pattern of Public expenditure should be such that the poor and weaker sectors receive the maximum benefits in the form of free education, medical facilities, old age pension and housing
- Canon of elasticity. Public expenditure should change according to the needs and requirements of the economy. It should be quite flexible so that it can be increased during depression and reduced during inflation
- Canon of economy. Public expenditure should be increased as to avoid the waste of public money. It should avoid all extravagance and useless expenditure. Expenditures on activities that lead to maximum social advantage should be avoided so as to protect the interest of the tax payer
- Canon of surplus. The government in as much as is possible should raise more revenue than its expenditure or rather should spend less than it earns, that is, the public authority must earn its living and pay its way like the ordinary citizens
- Canons of sanction. The canon of sanction states that no public expenditure should be incurred without the sanction of proper authority. There should be a competent authority like Ministry of Finance, to sanction all public expenditures which may allocate them according to the requirements of the country

REASONS FOR THE INCREASE IN PUBLIC (GOVERNMENT) EXPENDITURE IN UGANDA

- Rising costs of infrastructural development. The need to provide social and economic infrastructure such as transport and communication network that is necessary as they form the framework for economic growth and development
- Rising emergency funding due to frequency of natural hazards
- Systemic corruption/rising levels of corruption and embezzlement by public officials/rising costs of fights inflation
- Rising defence expenditure due to increasing social and political unrest. The existence of political unrest in some parts of the country like Kasese calls for increased government spending on defence to curb the political unrest
- Rising expenditure on international commitments/engagements
- Continuous over ambitious planning
- Increasing expenditure on the settlement of public debt. The increase in the public debt that has to serviced leads to increase in government expenditure
- High rate of inflation leading to rising costs of project implementation
- High population growth rate. This calls for increased government expenditure to cater for the demands of the population
- Rising admininstrative costs due to increasing wage bill due to increasing size of public service, new districts, frequent by elections, large cabinet etc

- Rising government expenditure on programmes to create employment, income etc

EFFECTS OF INCREASED PUBLIC EXPENDITURE

POSITIVE EFFECTS

- Increase in aggregate demand for goods and services
- Increase in the production of goods and services in the economy
- Leads to creation of more employment opportunities
- More government revenue is realized
- Leads to improvement in the social and economic infrastructure
- Promotes commercialization of the economy
- Creates political stability

NEGATIVE EFFECTS

- It is inflationary
- Causes scarcity of goods and services in the domestic market
- Way worsen the burden of the public debt
- May worsen the unemployment problem

ROLE OF PUBLIC EXPENDITURE IN DEVELOPMENT

- State spends on social and economic overheads eg hospitals and schools which are beneficials to everybody in the country
- Exploitation and development of idle potential eg mineral resources
- Balancing growth them to desired level of development ie the state may spend more money on depressed areas to bring them to desired level of development
- Used in servicing and management of national debt
- Subsides and grants which are given to local authorities for running of their administration, is a basic role of state expenditure