INTODUCTION TO PUBLIC FINANCE AND TAXATION THEORY

Published on May 12, 2015

LAUDEN CHEYO | Follow
Auditor at KLM CONSULT

INTODUCTION TO PUBLIC FINANCE AND TAXATION THEORY

Public Finance is the term, which has traditionally been used or applied to the packages of those policy problems, which involve the use of tax and expenditure measures. As a subject, public finance is a study of public sector economics. It is about the revenue, expenditure and debt operations of the government and the impact of these measures to the society. Public Finance is, therefore, about fiscal institutions, that is the tax systems, expenditure programs, and budget procedures, stabilization instruments, debt issues, level of government etc.

THE NEED FOR PUBLIC SECTOR:

From the economic point of view government, intervention is necessary because of what is known as Market failure in such functions as allocation of resources, distribution of income and stabilization of the economy.

(a) **Allocation Function:**

The provision of social goods or the process by which total resources used is divided between private and social goods and which chooses the mix of social goods. This provision of social goods is what is known as the allocation function. Market failure in the provision of social goods is chosen. This provision of social goods is what is known as the allocation function. Market failure in the provision of social goods arises because of the presence of public goods. These are goods we consume collectively and therefore one person who purchased the good can exclude no one from the benefits arising from consumption of such goods. To put id differently the benefits derived by anyone consuming a social good are ‘exterilised’ in that they become available to all others. Incase of private goods the benefits of consumption are ‘internalized’ with a particular consumer whose consumption excludes military defence, Law and Order (The Police), Judiciary, Air clearing etc.

The market mechanism is well suited for the provision of private goods. It is based on exchange, and exchange can occur only where there is an exclusive title to the property, which is to be exchanged. Application of the exclusion principle tends to be inefficient solution. This is not the case for social goods, as it will be inefficient to exclude anyone consumer from partaking in the benefits, when such participation would not reduce consumption by anyone else. For instance, you may cross the Salender Bridge as much as you can but this does not reduce the possibility available to others to use the bridge.

However, incases where benefits are available to all, consumers will not voluntarily offer payments to supplier of social goods. Hence, no voluntary payment is made especially where many consumers are involved. The linkage between producer and consumer is broken and the government must step in to provide for such goods.

- **Distribution Function:**

Again, the government has to intervene in order to adjust the distribution of income and wealth to ensure conference with what society considers a 'fair' or just state of distribution of income and wealth to ensure conformance with what society considers a 'fair' or just state of distribution. This fair or just distribution of income cannot be achieved under the market mechanism. Under the market mechanism, the distribution of income and wealth depends first of all on the distribution of factor endowment and then determined by the process of factor endowment and then determined by the process of factor pricing, which in a competitive market, sets factor returns equal to the value of marginal product. The distribution of income among individuals thus depends on their factor supplies and the prices which they fetch in the market.

Earning abilities differ, so does factor endowment, this distribution of income may or may not be in line with what society considers fair and just. It involves a substantive degree of inequality especially in the distribution of capital income, and through views on distributional income justice differ, most would agree that some adjustments are required.

Among various fiscal devices, redistribution is implemented most directly by:

- A tax scheme which combines progressive income taxation of high income households with a subsidy to low income households.
- Alternatively, redistribution may be implemented by progressive income taxes used to finance public services especially those such as public housing scheme, hospitals and other health care schemes, education schemes etc which particularly benefit low income households.

- A combination of taxes on goods purchased largely by high income consumers with subsidies to other goods, which are chiefly used by low-income earners.

1. **Stabilization Function**

Fiscal policy has to be designed by the government to maintain or achieve the goals of high employment, a reasonable degree of price level stability, soundness of foreign accounts and an acceptable rate of economic growth. Fiscal policy is needed for stabilization of the economy. Full employment and stability do not come about automatically in a market economy but require public policy guidance. Without it, the economy tends to be subject to substantial fluctuations, and it may suffer firm sustained periods of unemployment or/and inflation.

Sources of Government Revenue

To perform the aforementioned functions efficiently the government must have resources or funds to finance the said activities. The government raises much of its finance through taxation. Taxation is the most preferred sources of revenue among governments' worldwide. Apart from ensuring constant and uninterrupted flow of revenue to government revenue, taxation serves other fiscal policy objectives as well.

Other Sources of Government Revenue include:

- Borrowing:

The government may borrow funds from both internal and external sources. Internal sources include all financial institutions such as Banks, Insurance companies and social Security institutions.

External sources include bilateral (between governments) multilateral sources such as IMF, World Bank etc.

- Grants and Aids:

Grants are funds given to the government for a specific purpose, e.g. construction of road, purchase of rice etc. An aid is a general monetary assistance given to the government with a donor country not specifying its particular use.

- Dividends from its corporations:

The government may own shares in various corporations from which it may receive cash dividend.

- User Charges:

These include port and airport services charges.

- Fines imposed as punishment or damages for contravening various Laws enacted by the government. For instance driving a defective motor vehicle may attract payment of a certain amount of money to the government as fine.

- Licenses and other fees.

- Sale of government bonds and securities.

Non of these sources however can bypass taxation in terms of bringing much revenue to the government. Most of these sources are infact unstable and unreliable as they are subject to unpredictable fluctuations and willingness of certain individuals or credit worth-ness

WHAT IS TAXATION

As a subject, taxation is a study of how the government imposes on and collects taxes from, the income and wealth of individuals and corporations to finance its social and regulatory activities. The study of taxation usually covers the entire tax system which is made up of Tax policy, law and administration.

The government, therefore, derives its revenue from taxes. A tax is compulsory and mandatory contribution to the government from its subjects. It is mandatory in the sense that there is a legal document giving the government the mandate to collect such contribution: However, if carefully analysed this definition may include such payments as fines and penalties paid to the government. The most dependable and reliable definition of what is a tax was given by Hugh Dalton who defined a tax as “a compulsory contribution imposed by a public authority, irrespective of the exact amount of services rendered to the taxpayer in return, and not imposed as a penalty for any legal offence".

Imposition of a tax, therefore, creates a tax liability upon those liable to pay the imposed tax. A tax liability is always expressed in monetary terms, and it is worth noting here that any monetary liability creates a burden. In other words imposition of a tax creates a tax burden on taxpayers.

EQUITY:

In taxation, equity refers to fairness in the distribution of the tax burden. For compliance purposes and to fend off public outcry the tax burden should be apportioned in more equitable manner. Two principals have long been developed as a guide to equity. These are:

- The Benefit Principle: This approach dictates that taxes are apportioned to individuals according to the benefit they derive from government activities and spending. Taxes therefore should be treated as a payment for the goods and services provided by the government.

- The ability to pay principle: This is concerned with the equitable distribution of taxes according to the stated taxable capacity or ability to pay of an individual or group. The emphasis in this approach is put on redistribution of income, that, those with higher incomes should sacrifice more so that there can be proper and equitable redistribution of income.

Both principles are calling for equality, no one then will quarrel with a saying that 'those who are essentially equal should be taxed equally' (Horizontal Equity), and if equals are to be taxed equally then the reverse is also true, that unequal to be taxed unequally (Vertical Equity)

To attain the much needed equally taxes are made to be proportional, progressive or regressive depending upon whether they take from high income earners the same fraction of income as tax than they take from low income people.

However the general philosophy of Benefit or ability to pay alone does not answer the question of best tax formula and hence the need for political process. In practice all the principle are put into use.

TAX BASE AND TAX YIELD

To clearly understand the concept of tax base, we need to classify taxes into two classes:

1. Direct Taxes
2. Indirect Taxes

Direct Taxes are levies directly on the income of individuals or corporations. This includes income tax, Payroll levy, and other withholding taxes. A tax base for direct taxes therefore is income. In other words, direct taxes are tax based income. The amount of tax revenue (tax yield) from direct taxes will therefore depend on income of individuals and corporations.

Indirect Taxes are levied on goods or services. The tax base for indirect taxes is therefore the goods produced and services rendered in a particular economy. Tax yield from indirect taxes will therefore depend on goods produced and services rendered in the economy. The amount of tax revenue collected from a particular tax will therefore depend on, among other how wide the tax base or coverage of that particular tax is.

Some advantage of Direct Taxes:

- They don’t have inflationary tendencies. Increase or decrease in tax rates usually does not affect the general price level.
- When made progressive direct taxes tend to be highly equitable.

Disadvantages:

- In a cash economy like ours where general level of education of taxpayers is low, it is difficult to determine taxable income of taxpayers.
- Direct tax Laws are difficult to understand as a result the lead to disputes.

- Direct taxes are unpopular as they directly affect the disposable income.
- Progressiveness of direct taxes may be disincentive to hard work, and therefore discourage savings and investment.
- They have a very narrow tax base
- Tax incidence cannot be shifted.

Advantages of Indirect Taxes:

- They are easy to collect
- They provide a wide tax base and hence revenue potential
- As taxes are included in the price of taxable goods and services, the tax incidence is shifted to the last consumer.

Disadvantages:

- They tend to be regressive especially when imposed on goods and services consumed by low income earners.
- They have inflationary tendencies. Increase in tax rates is likely to disturb the general price level.

Principles of a Good Tax System:

Taxation being compulsory contributions from individuals, or business entities to the government to defray the public expenditures by the government has some effects in the economy as well as in the social life of the society. The effect might be constructive to the economy or might damage the economy. In order then to avoid/minimize damage to the economy there are criteria/principles for evaluating tax systems. These criteria are also called Canons of Taxations.

Canons of Taxation

Equity: Equity entails that taxes should be levied in such a way that they promote fairness. The concept of from each according to his ability to pay or benefits received are really what the principle of equity is all about a tax system that takes away proportionately more income from higher income earners than from lower income earners is the termed as a progressive tax system. In equity, a progressive rat structure and the minimum exemption policy should characterize the tax system. Thus, equals should be treated equally and unequal to be treated unequally.

Simplicity: A tax system ought to be simple. Simplicity of the tax system means the taxpayer should be able to understand the system and the tax base should be known clearly. The taxpayer should be able to compute his/her liability and the penalties involved for any neglect or failure to comply with tax law. The amount should not be the prerogative of the tax collector, as this will put the taxpayer to disadvantage and at the mercy of the collector and may make tax system arbitrary.

Economy: The administration of tax system should be least expensive in terms of both manpower and material. The cost benefit analysis is emphasized, as it does not make sense to spend more than the revenue collected. Optimization of collection costs is called for to judge whether a tax system is uneconomic or not, both pecuniary and non-pecuniary costs should be taken into account.

Certain: The imposition of tax should yield the expected revenues in order to assist government forward planning. Taxes on some commodities are certain while on others are fairly uncertain. On the other hand, this criterion advocates that the taxpayer ought to know precisely and exactly as regards the time of payment, the manner of payment and the amount to be paid.

Convenience: This calls for tax to be levied at the time and n the manner in which it is most likely to be convenient to the taxpayer. The system that allows the payment of tax at month end, immediately after crop harvest seasons or provides for the payment of tax through such devices as PAYE or other withholding arrangement can be regarded as convenient to the tax-payers; while a tax system that places heavy tax burden on tax-payers long after the income is exhausted is an inconvenient one.

Elasticity of Tax to changes in the tax base: A good tax system should be elastic to changes in the Tax base; the tax is elastic when the amount of revenue it yields increases as fast or faster than the growth of income or the economic or the economic activities. The elastic tax system yields adequate revenue for planned projects.

LAUDEN CHEYO
Auditor at KLM CONSULT
11 articles

Follow

12 comments

Newest

Leave your thoughts here…

Eddie Chisakulo

Mineral Scientist at Copperbelt University. PhD Student (Mineral Economics)

1w

Good
concepts. Thanks .

Like Reply

Jerome Kasangaki

--

3w

good
idea, thanks

Like Reply

There are 10 other comments. Show more.

Top stories from Editors' Picks

What Stock Investors Need to Know, and Why

Mohamed El-Erian on LinkedIn

Nearly booted from high school, Mike Tuchen learned a lesson he uses as a CEO

Jon Fortt on LinkedIn

Why "but he never harassed me" isn defense.

Elizabeth Spiers on LinkedIn

Looking for more of the latest headlines on LinkedIn?

Discover more stories