PUBLIC FINANCE

Public finance refers to the activities carried out by the government associated with raising of finances and the spending of the finances raised (it is the study of how government collects revenue and how it spends it)

The components of public finance are;

i. **Public revenue**
ii. **Public expenditure**
iii. **Public debt**

   i. ***Public revenue*-refers to the revenues (income) and resources received by the government from different sources.**
   ii. ***Public expenditure*-refers to the resources spent by the government.**
   iii. ***Public debt*-refers to the money and resources borrowed by the government.**

<u>Purpose of public finance</u>

i. ***Provision of essential goods and services*. The government has a responsibility of providing its citizens with essential goods and services such as security,health,schools,drought control, law e.t.c such facilities and services may not be adequately covered by the private sector because of the high costs involved and risks.**
ii. ***Encouraging consumption of certain commodities*-The government may encourage consumption of certain commodities e.g. maize by subsidizing on their productions or lowering their taxes.**
iii. ***Controlling consumption of certain commodities*-The government may also encourage consumption of some commodities e.g. cigarettes and alcohol by imposing heavy taxes on them.**
iv. ***Promotion of Balanced regional development*-This may be done by initiating economic projects in areas that are under developed/lagging behind.**
v. ***Wealth Redistribution*-This is done by heavily taxing the rich and using the money raised to provide goods and services that benefit the poor**
vi. ***To promote economic stability*-Economic instability may be caused by factors such as unemployment. Such problems can be solved through public expenditure in projects that generate employment such as 'kazi kwa vijana'**

vii. *Creation of a conducive Business Environment*-**Through public expenditure, the government may develop infrastructure such as roads, electricity, security e.t.c thereby creating a conducive environment for businesses to thrive in.**

viii. *To raise government revenue*-**Through public finance, the government raises revenue which it uses in provision of essential goods and services to the public.**

ix. *Improving balance of payment*-**This may be done by improving heavy taxes such as customs duty to discourage importation.**

Sources of public finance

There are two major sources of public finance i.e.

i. **Public revenue**
ii. **Public debt (government borrowing)**

i. **Public revenue-This is the income that the government gets from its citizens. The main sources of public revenue are;**

a. *Tax;* **This is a compulsory payment levied by the government on individuals and firms without any direct benefit to the payer.**
b. *Fines and penalties*-**These are the charges imposed on individuals, firms and corporations who break the laws of the country.(offenders)**
c. *Fees;* **These are the payments charged by the government for the direct services it renders to its people e.g. road licence fee, marriage certificate fee and import licence fee.**
d. *Rent and rates;* **Charged on use of government properties e.g. game parks, forests e.t.c**
e. *Eschiats;* **Income obtained from properties of persons who die without legal heirs or proper wills. Such people's properties are taken over by the state.**
f. *Dividends and profits;* **These are the income received from the government direct investments e.g. income/surplus from public corporations.**
g. *Interest from loans*-**This is the interest on loans advanced by the government to firms and individuals through its agencies such as ICDc,AFC e.t.c**
h. **Proceeds from scale of government property.**

ii. **Public debt (Government borrowing)-This is the money that the government borrows when public revenue is insufficient to meet all its financial obligations.**

Government borrowing is also referred to as ***national debt*****. It includes all outstanding borrowing by the central government, local authorities and government corporations.**

These are two majorly two sources of public debts;

a. **Internal borrowing**
b. **External borrowing**

a. Internal borrowing

This refers to borrowing by government from firms and individuals within the country. This may be done through;

Open market operation; **the government sells its securities such as treasury bonds and treasury bills. This however has a disadvantage of causing 'crowding out effect' where the government leaves the private investors with little to borrow from.**

b. ***External borrowing***

This refers to government borrowing from external sources. It may either be on a ***bilateral or multilateral*** **basis.**

Bilateral borrowing is where the government borrows directly from another country.

Multilateral borrowing is where the government borrows from international financial institutions such as international monetary fund (IMF), World Bank, African Development bank e.t.c.such bodies get finances from various sources which they lend to their member countries who are in need of such funds.

Generally, external borrowing has strings attached. The borrowing country is expected to meet some set conditions, sometimes adversely affecting some sectors of the economy.

The total internal borrowing (internal debt) added to the total external borrowing (external debt) constitutes the national debt.

Classes of public (National debt)

These are two classes of national debt;

i. **Reproductive debt**
ii. **Dead-weight debt.**

i. ***Reproductive debt***

This is borrowed money used to finance project(s) that can generate revenue. Such projects, once started may become self sustaining and may contribute towards servicing/repaying the debt. E.g. money used to finance irrigation schemes, electricity production e.t.c.

ii.***dead-weight debt***

This is borrowed money that is used to finance activities that do not generate any revenue. Examples are money used to finance recurrent expenditure e.g. payment of salaries or for famine relief e.t.c

Dead-weight debt is a burden to members of the public since they are the ones who are expected to contribute towards its repayment.

Factors to consider before the government decides whether to borrow internally or externally

This refers to how the government spends the finances it has raised on behalf of its citizens.

Categories of government expenditure

a) **Recurrent expenditure**
b) **Development expenditure**
c) **Transfer payments.**

a. Recurrent expenditure

This refers to government spending that takes place regularly e.g. payments of salaries to civil servants, fuelling of government vehicles e.g.

Every financial year, the government must allocate funds to meet such expenditure.

Recurrent expenditure is also known as *consumption expenditure.*

b. Development expenditure

This is also referred to as *capital expenditure* .It is government spending on projects that facilitate economic development. Such projects includes construction of *railway lines, roads, airports, rural electrification e.t.c*

Once completed expenditure on such projects ceases and may only require maintenance.

c. Transfer payments

This is expenditure on things/people who do not directly contribute to a country's national income. Such expenditure include money spent on famine relief, pension, bursaries e.t.c

PRINCIPLES OF PUBLIC/GOVERNMENT EXPENDITURE

These are the considerations that are necessary before any expenditure can be incurred by the government.

They include;

a) ***Sanctions;* Every public expenditure must be approved by the relevant authority like parliament.**

b) ***Maximum social benefit;*** **Any public expenditure must be incurred in such a way that majority of the citizens are able to reap maximum benefit from it e.g. improved living standards and quality of life.**
c) ***Flexibility /elasticity*-The policy on public expenditure should be flexible enough to meet prevailing economic situations i.e. it should be possible to increase or decrease the expenditure on projects depending on the prevailing circumstances e.g. during drought, it should be possible to spend on famine relief.**
d) ***Economy*-public expenditure should be planned carefully and prudently to avoid any possible waste.**
e) ***Proper financial management (Accountability)*-public funds should be well managed. This should be facilitated by maintenance of proper records which should be audited as required.**
f) ***Productivity*-The biggest proportion of public expenditure should be spent on development projects and less on non-development projects.**
g) ***Equity*-Government expenditure should be distributed equitably to all sectors of the economy in order to reduce income and wealth inequalities.**
h) ***Surplus*-Surplus revenue collected should be saved for emergencies or for when collection of revenue is below projections.**

TAXATION

***Tax;* is a compulsory payment by either individuals or organizations to the government without any direct benefit to the payer.**

***Taxation*-refers to the process through which the government raises revenue by collecting taxes.**

Purposes/reasons for taxation

i. **Raising revenue for government expenditure. This is the main reason for taxation.**
ii. **Discouraging /controlling consumption of certain commodities e.g. alcohol and cigarattes which are considered to be harmful.**
iii. **Discouraging importation of certain commodities in order to protect local industries. This is done by imposing heavy taxes on such commodities.**
iv. **Controlling inflation. Taxation reduces money supply by reducing peoples 'disposable' income thereby controlling inflation.**
v. **Reducing inequality in income distribution; this is done by taxing the rich heavily and using the finances raised in provision of goods and services that benefit the poor.**
vi. **Influencing locations of businesses. This is done by taxing businesses located in urban areas heavily and those in rural areas lightly hence businesses moving to rural areas.**

vii. **Correcting unfavorable balance of payments. High taxes are imposed on imported commodities thereby discouraging their importation leading to an improvement in the balance of payments.**

viii. **To protect the key selectors of the economy such as the agricultural sector, by stimulating their growth.**

<u>Factors that determine the amount of money raised through taxation</u>

i. **Distribution of incomes**

ii. **Social and political factors**

iii. **Honesty and efficiency of tax authorities**

iv. **Citizens level of real income**

v. **Economic structure of the country i.e. relative size of the country's commercial and subsistence sectors.**

<u>Principles of taxation</u>

These are the characteristics that a good tax system should have. They are also referred to as the *cannons of taxation.*

A good tax system should be;

i. ***Equitable/principle of equity*-Every subject of the state should pay tax in proportion to their income. A tax system should therefore have horizontal and vertical equity.**

***Horizontal equity* means that those at the same level of income and circumstances should pay the same amount of tax.**

***Vertical equity* means that those earning higher incomes should pay proportionately higher amounts of tax than those earning less.**

ii. ***Certain/principle of certainty*-The tax that an individual should pay should be clear in terms of the amount, time and manner in which it should be paid. The government should also be fairly certain of the amount of tax expected so that planning can be easier.**

iii. ***Convenient/principle of convenience*-Tax levied ought to be convenient to both the contributor and collector, it should be levied at a time when the payer has money and mode of payment should be convenient to both the payer and the payee.**

iv. ***Economical/principle of economy*-The cost of collecting and administering the tax should be lower than the tax so collected.**

v. ***Flexible/principle of flexibility*-It should be readily adaptable to changing economic times i.e. when the economic conditions of the people improve it should give raised revenue e.g. VAT**

vi. ***Ability to pay/non*-oppressive-A tax system should be designed in a way that the amount charged is not too high to the extent that the contributors are unable to pay or is discouraged from working hard.**

vii. ***Diversified/principle of diversity*-There should be different types of taxes so that the tax burden is on different groups in the society. This also ensures that the government has money at all times.**

viii. ***Simplicity*-A good tax system should be simple enough to be understood by each tax payer. This will motivate them to pay tax.**

ix. ***Elastic/principle of elasticity*-The tax system should be able to generate more revenue for the government by targeting items of mass consumption.**

IMPACT AND INCIDENCE OF TAX

***Impact of tax;* The burden of tax on the initial person**

***Incidence of tax;* The final resting place of the tax burden.**

The person on whom tax is initially imposed may either bear the whole burden or pass part or the whole burden to someone else. E.g. for manufactured goods, the impact of the tax is on the manufacturer and the manufacturer may pass the incidence of the tax to the consumer.

If the manufacturer only passes part of the burden to the consumer, then the incidence of the tax wil be partly on the manufacturer and partly on the consumer.

CLASSIFICATION OF TAXES

Taxes are classified according to;

i. **Structure of the tax**

ii. **Impact of the tax on the tax payer.**

a) **According to the structure**

In this case, taxes are classified according to the relationship between the amount paid on tax and the income of the tax payer. These are:

i. **Progressive tax**

ii. **Regressive tax**

iii. **Proportional tax**

a. Progressive tax

This is a type of tax where the rate/amount paid increases proportionately with increase in income.e.g tax may be as follows

Income	Rate
0-5000	20%
5001-10000	25%
10001-15000	30% e.t.c

-In progressive tax, those with higher income rates remit a higher proportion of their income as tax compared to those in lower income brackets.

This type of tax is based on the belief that one only needs a certain amount in order to have a decent standard of living.

Advantages of progressive tax

- **It reduces income inequality as the rich are taxed more**
- **It encourages people to work harder/more in order to maintain their standard of living**
- **The revenue collected is higher**
- **The unit cost of collecting tax reduces as the tax increases.**

Disadvantages of progressive tax

i. **It is oppressive-some people are taxed more than the others and punishes people for their hard work.**
ii. **It may discourage people from working more as any additional income goes tax**
iii. **Investors may be discouraged from venturing into risky but more profitable businesses as these would attract more tax**
iv. **It assumes that people earning the same amount of money/income have similar needs and ability to pay tax-which in reality may not be true.**
v. **It can lead to tax evasion by taxpayers falsifying their level of income.**

b. Regressive tax

This is a type of tax that takes a higher proportion of low income earners as compared to high income earners. The fax burden falls more heavily on the poor (opposite of progressive)

Example: sales tax where people pay the same amount irrespective of the level of income.

The assumption is based on the understanding that the one who deems it necessary to buy a certain products considers the utility derived from it to be equal to its price, which includes tax.

c. Proportional Tax

This is a type of tax where the rate of tax remains the same irrespective of the level of income or value of property to be taxed e.g. if the rate is 20% then a person who earns ksh.5000 will pay 20/100 x5000=ksh.1000

Ksh.10, 000 will pay 20/100x10,000=ksh.2000 e.t.c

Example: corporation tax where companies are expected to pay a fixed proportion of their profits as tax.

d. Digressive tax

This is a type of tax where the tax rate increases up to a given maximum after which a uniform tax rate is levied for any further income.

Classification according to impact on the tax-payee

Based on the impact, the tax has on the tax payer; tax may be classified as either;

a. **Direct tax**
b. **Indirect tax**

a. Direct tax

These are taxes where the impact and the incidence of the tax are on the same person. It is not possible to shift/pass any part of the tax burden to anybody else.

This type of tax is based on incomes, profits and property of individuals as well as companies.

They include:

i. Personal income tax

This is a tax that is imposed on incomes of individuals and is usually progressive in nature.

Example pay-As You-Earn (PAYE) for salaries.

In most cases it is paid through check-off system where the employer deducts it from the employee's salary and remits it to the tax authorities.

ii. Corporation tax

This is tax levied on profits of companies. It is usually proportional in nature.

iii. **Stamps duty**

This is tax paid in areas such as conveyance of land or securities from one person to another.

iv. **Estate (death) duty**

This type of tax is imposed on property transferred after the owners' death. The tax helps in raising government revenue and also in redistributing income since the inheritor has not worked for it.

v. **Wealth tax**

This is tax levied on personal wealth beyond a certain limit.

vi. **Capital gains tax**

This is tax levied on gains realized when a fixed asset is sold at a price higher than the book value.

vii. **Capital transfer (gifts) Tax**

This is tax imposed on the value of property transferred from one person to another as a gift. The tax is designed to seal loopholes whereby a wealthy person may try to avoid tax by transferring his/her property to a friend or a relative as a gift.

This type of tax is progressive in nature. It however does not affect transfers between spouses or to charitable organizations.

Merits/advantages of direct taxes

i. ***Economical in collection;*** **most of direct taxes are collect at source and the cost of collecting them is fairly low.**
ii. ***Tax revenue is certain;*** **the tax payer knows what and when to pay and the government knows how much tax revenue to expect at what time (can be collected from the annual tax returns in advance)**
iii. ***Equitable /equity;*** **they facilitate fair distribution in tax contribution as people pay according to the size of their income.**
iv. ***Simplicity /simple to understand;*** **they are easy and simple to understand by both the tax payer and the collector.**
v. ***Does not affect the price of goods and services;*** **direct tax does not cause inflation as it only affects consumer's disposable incomes and not the prices of goods and services.**

vi. ***Brings redistribution of wealth;*** **direct taxes are progressive in nature hence the wealthier members of the society are taxed more than the poorer members of the society.**

vii. ***Civic consciousness;*** **tax payers feed the pinch of paying tax and thus take a keen interest in government expenditure.**

viii. ***No leakages;*** **loss of collected revenue is minimized as the tax is paid directly to the tax authorities and not through middle men.**

ix. ***Desirable;*** **the tax is desirable because it only affects people who fall within the jurisdiction of income tax and corporation tax.**

x. ***Elastic/flexible;*** **the tax is flexible in that it can be expanded to cover as many areas as desirable.**

It can also be raised or reduced according to the needs of the economy.

DEMERITS OF DIRECT TAX

i. ***Encourage avoidance and evasion;*** **whenever possible people come up with ways of reducing the amount of tax payable by falsifying information or just ignoring payment.**

ii. ***Discriminatory /not imposed on all citizens;*** **direct taxes are not paid by all citizens as low income earners who do not fall within the tax brackets are exempted**

iii. ***Discourage investment/deterrent to investment;*** **Heavy taxation on profits discourage people from investing in risky but profitable businesses**

iv. ***Discourage work/deterrent to work;*** **High rate of direct tax may deter people from working harder as people may opt for leasure instead of working extra time.**

v. ***Encourage capital flight;*** **high taxes such as corporate tax make foreigners to withdraw their investments and transfer them to countries with lower taxes.**

vi. ***Unpopularity;*** **the burden of the tax (incidence and impact) of tax is borne by the tax payer directly and at once. This makes direct taxes very unpopular.**

vii. ***May inconvenience the tax payer; the tax payer has to comply with complicated formalities relating to sources of income as well as the expenses incurred while generating it. This may force the tax-payer to engage the services of tax experts who have to be paid.***

viii. ***Lack of civic awareness;*** **on tax payers are not interested in scrutinizing government expenditure as they do not feel the pinch of paying tax.**

b. ***Indirect tax***

These are taxes in which the impact is on one person and the incidence is partially or wholly on another person. The tax payer may shift either the whole or part of the tax burden to another person.

Such taxes are usually based on the expenditure on goods and services and include the following:

i. **Sales tax: this is based on the sales made and may be assessed either as a percentage of the sales or a fixed amount e.g. sh.2 per every kilograms sold. The tax may be collected at one point or various points of sale. In Kenya, sales tax has been replaced by V.A.T**
ii. **VALUE ADDED TAX (V.A.T): this is the tax that is levied on the value that a business adds borne by the consumer in the final price.**
iii. **Export duty: this is a type of tax that is levied on exports. The objective may either to raise revenue or discourage the exploitation of some commodities.**
iv. **Import duty: This is tax levied on imported products,**

For the following reasons.

- **Raising government revenue**
- **Reducing incidences of dumping**
- **Discouraging consumption of imported goods with a view of boosting local production**
- **Protecting local industries**

v. **Excise duty: This is a type of tax that is imposed on goods that are manufactured and sold within a country.**

Its purpose includes;

- **Raising revenue for the government**
- **Discouraging the consumption of some commodities such as beer and cigarettes.**

MERITS OF INDIRECT TAX

I. **Can be used selectively; It can be used selectively to achieve a given objective e.g. consumption of some commodities.**
II. **Tax payment is voluntary; indirect tax is only paid by those who consume the tax commodities therefore those who do not want to pay the tax would only need to avoid taxed commodities.**
III. **Difficult to evade; the tax cannot be evaded because it is part of the price of the commodity. All those who buy the commodity taxed must therefore pay the tax.**
IV. **Wide coverage/broad based; the tax is levied on a wide range of essential commodities thus a high amount of revenue is collected.**
V. **Stimulate effort; indirect taxes if increased increases the prices of goods and services. People who want to maintain the same living standards will therefore have to work harder to be able to buy/affect the same goods and services.**
VI. **Convenient; the tax is paid in bits as one buys the goods and services. The tax is also hidden in the price of the commodity and the payer may not be aware of it.**
VII. **Flexible; flexible; the government can raise or reduce the tax rate to suit the prevailing economic situation in a country.**

DEMERITS OF INDIRECT TAXES

1. **May fuel inflation; continued increase in indirect taxes may fuel inflation as it directly increases the prices of goods and services.**

2. **Less equitable/regressive; the same amount is charged on both the high and the low income earners making the tax burden to fall heavily on the low income earners. The low income earners end up paying a larger proportion of their income as tax.**
3. **Can be avoided; indirect taxes can be avoided by people who do not consume the taxed commodity.**
4. **Encourages falsification of records; traders may falsify their rewards in order to pay less tax.**
5. **Lack of civic/contributors awareness; the tax is hidden in the price of the commodities therefore the tax payers are not aware that they are contributing anything to the state.**
6. **Expensive to administer/expensive in collection; the government must employ many tax inspectors making indirect taxes expensive in collection and administration.**
7. **Uncertainty in revenue collection; the government may not predict the amount of revenue yield as it is not easy to forecast sales and people can also not be forced to buy the taxed commodities.**
8. **Might interfere with resource allocation; indirect taxes increases the prices of commodities and can therefore force consumers and producers to shift to the consumption and production of commodities that are not taxed.**
9. **Discourages savings; increased expenditure due to increased prices will lead to low saving and hence low investments.**

END

- Marking schemes to primary school past papers.
- K.C.P.E past papers.