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**NATIONAL OPEN UNIVERSITY OF NIGERIA**

**Taxation and Fiscal Policy**

**ECO 440**

**SCHOOL OF ARTS AND SOCIAL SCIENCES**

**COURSE GUIDE**

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## **Introduction**

Taxation and Fiscal Policy (ECO 442) is a two-credit and a semester course for undergraduate economics student. This course builds on the foundation laid in Public Sector Economics. The course is made up seventeen units spread across fifteen lectures weeks. This course guide articulates the role of taxation and fiscal policy for economic growth and development and how fiscal policy through variations in government expenditure and taxation affects national income, employment, output and prices. It tells you about the course, the course materials and how to work through the course material to derive maximum benefits. It also suggests general guidelines for the amount of time required for each unit to achieve the course aims and objectives. Answers to the tutor marked assignments (TMAs) are also included.

### **Course Content**

This course concerns the taxation and expenditures policy of the government and its effects on the macro-economy. It primarily deals with the study of fiscal policies of government and the role of government in their formulation and implementation. It involves an examination of using fiscal policy and taxation to achieve macro-economic objectives of price stability, growth, full employment and balance of payment equilibrium. It deals with the economics of public sector as the sector operates in a mixed economic system. It is basically on the macro-economic aspects of economic theory and analysis. The topics covered include the overview of the fiscal functions, redistribution function of government, taxation, evaluation of public expenditure, economics of public debt, fiscal federalism, fiscal federalism in Nigeria, and development finance. More so, since public sector interacts with private sector in her regulatory activities, the course considered both sectors in the analysis. Although, the subject matter is traditionally referred to as public finance, the course deals with the real and the financial aspects of the problem.

### **Course Aims**

The aims of this course are to provide an in-depth understanding of the economics as regards

- (i) Taxation and Fiscal policies decisions to influence levels of output, employment and prices.
- (ii) To expose students to tax laws and administration, functions of tax, different types of taxes, benefit of taxes, efficiency of taxes and incidence of taxes.
- (iii) To stimulate student's knowledge about efficiency and equity functions of taxation and expenditure policy of government, in particular the intergenerational equity.
- (iv) To familiarize students with distribution of after-tax incomes function of taxation and fiscal policy of the government.
- (v) To expose students to the Stabilization policy of the government with the use of taxation and expenditure policy of the government.
- (vi) To expose students to short-run and long-run functions of fiscal policy of the government.

### **Course Objectives**

There are general and specific-units objectives the course is set to accomplish in order to achieve the purpose of this course. The units' objectives are itemized at the beginning of each unit; and students should go through them before working through each unit. Students can as well refer to them in the course of their study to ensure there keeping with the pace of the teaching. This will assist students in

achieving the task involved in the course. The objectives serve as study guides, such that each student could know if he or she is grasping the knowledge of each unit set objectives. Therefore, the students are expected at the end of the course to be able to:

- (i) Describe the tools of fiscal policy – taxation and government spending.
- (ii) Discuss the potential and limitations of fiscal policy to promote national economic goals of full employment, stability, and growth.
- (iii) Evaluate fiscal policy – the relationships between consumption and output, tax policy and government spending changes.
- (iv) Understand how economic perspectives and theories about fiscal policy change over time.
- (v) Review national economic goals: What can government do effectively and what it cannot do effectively to help the nation achieve its economic goals? What are the possibilities and limitations of fiscal policy?
- (vi) Discuss public choice theory. Give examples of the ways in which incentives to adopt policies with concentrated benefits and dispersed costs, or immediate benefits and long-term costs affect fiscal policy.
- (vii) Understand the social, political, and historical forces that shaped fiscal institutions and determine the formulation of contemporary fiscal policy.
- (viii) Understand the role of fiscal policy in the economic growth and development of a country.
- (ix) Understand the techniques and stances of fiscal policy.

### **Working through this Course**

This course requires spending quality time to study. The content of this course is comprehensive and presented in a clear and digestible language. The presentation style is adequate and the contents are easy to understand. To complete this course successfully, it is necessary to read the study units, referenced materials and other materials on the course. Each unit contains self-assessment exercise called Student Assessment Exercise (SAE). Students will be required to submit assignments for assessment purposes and there will be final examination at the end of the course. Students should take adequate advantage of the tutorial sessions because it is a good avenue to share ideas with their course mates. The course will take about 15 weeks and the components of the course are outlined under the course material sub-section.

### **Course Materials**

The major components of the course are listed as follows:

1. Course Guide
2. Study Unit
3. Textbook
4. Assignment file
5. Presentation schedule

### **Study Units**

There are 17 study units; grouped into five modules in this course. The study units are listed below:

<b>Module One</b>	<b>An Overview of Fiscal Functions</b>
Unit 1	The Allocation Function
Unit 2	The Distribution Function
Unit 3	The Stabilization Function
Unit 4	Co-ordination or Conflict of Functions

**Module Two                      Public Revenue**

Unit 1	Public Revenue: General Consideration
Unit 2	Taxation
Unit 3	Tax Assignment and Tax Shifting
Unit 4	Taxation and Fiscal Policy

<b>Module Three</b>	<b>Public Expenditure</b>
Unit 1	Public Expenditure: General Consideration
Unit 2	Evaluation of Public Expenditure
Unit 3	Public Expenditure and Fiscal Policy

<b>Module Four</b>	<b>Economics of Public Debt</b>
Unit 1	Introduction to Public Debt Economics
Unit 2	Public Debt and Budget
Unit 3	Debt Burden and Intergenerational Equity

<b>Module Five</b>	<b>Fiscal Federalism</b>
Unit 1	Intergovernmental Fiscal Relations
Unit 2	Fiscal Federalism in Nigeria
Unit 3	Development Finance

Each study unit requires at least two hours of teaching and it include the objectives, main content, self-assessment exercise, conclusion, summary and reference and the Tutor-Marked Assessment (TMA) questions. The self-assessment exercises may require group discussions among the students.

Textbooks and other resources are also listed in the reference section for further reading. These materials are meant to be consulted for adequate understanding of the course. The self-assessment exercise and tutor-marked assignment (TMA) questions are also provided for an in-depth understanding of the course. All these will aid the achievement of the stated objectives of the course.

### **Textbooks and References**

Recommended books and e-books for this course can be downloaded online as specified for reference and further Reading. There may be more recent editions of some of the recommended textbooks and you are advised to consult the newer editions for further reading.

Aboyade, O. and A. Ayida (1982) “The War Economy in Perspective” *The Nigerian Journal of Economic and Social Studies*, Vol. 10, No. 1:13-37.

Central Bank of Nigeria (2000) *Issues in Fiscal Management: Implications for Monetary Policies in Nigeria*. Conference Proceedings, Third Annual Monetary Policy Conference, 11<sup>th</sup> -12<sup>th</sup> Dec., Abuja.

Central Bank of Nigeria (2000) *The Changing Structure of the Nigerian Economy*, Research Department.

Colm, G. (1970) *Essays in Public: Finance and Fiscal Policy* York: Oxford University Press. 1955, Chapter 1.

Houghton. R. W. (1970) *Public Finance*, Baltimore: Penguin (ed.) 1970.

Egwaikhide, F. O. (1988) “The Analysis of Structural Shift of Government Revenue in Nigeria, 1960-1982”, *The Nigerian Journal of Economic and Social Studies*, Vol. 30, no. 2: 131-147.

Egwaikhide, F. O. (1992) “State Expenditure in Nigeria: A Historical Sketch”, *Annals of the Social*

- Science Council of Nigeria*, no.4:49-61.
- Iwayemi A. (1995) *Macroeconomic Policy Issues in an Open Developing Economy: A Case of Nigeria*. (ed.). NCEMA, Ibadan.
- Morgan, D. R. (1979) "Fiscal Policy in Oil Exporting Countries, 1972-78", *IMF Staff Papers*, Vol.26:55-86.
- Musgrave R. A. and P. B. Musgrave (1989) *Public Finance in Theory and Practice*. International Edition, McGraw-Hill. ISBN 0-07-044127-8.
- Musgrave, R. A. (1969) *Fiscal System*, Yale University Press: New Haven.
- Peacock, A.T. and J. Wiseman (1961) *The Growth of Public Expenditure in the United Kingdom*, Oxford University Press, London.
- Pigou, A. C. (1928) *A Study in Public Finance*. London: Macmillan, 1928, PP 19-20.
- Phillips, A. O. (1995) "Fiscal Impact of Government on Business" *a Paper presented at NISER's National Executive Policy Seminar*, Ibadan, February 14-16
- Hinricks, H. (1966) *A General Theory of Tax Structure Change During Economic Development*, Harvard Law School, Cambridge, Massachusetts.

### **Assignment File**

An assignment file and marking scheme will be made available to you. This file provides you with the details of the work you must submit to your tutor for marking. The marks obtained from these assignments shall form part of your final mark for this course. Additional information on assignments will be found in the assignment file and in this Course Guide in the section on assessment.

There are six assignments in this course. The six assignments will cover:

- Assignment 1 – All TMA's questions in Units 1 – 4 (Module 1)
- Assignment 2 – All TMA's questions in Units 1 – 4 (Module 2)
- Assignment 3 - All TMA's questions in Units 1 – 3 (Module 3)
- Assignment 4 – All TMA's questions in Units 1 – 3 (Module 4)
- Assignment 5 – All TMA's questions in Units 1 – 3 (Module 5)

### **Presentation Schedule**

The presentation schedule in the course material provides you with the dates for the completion and submission of your TMAs and attending of tutorials. You should remember to submit all assignments at the appropriate date and time. You should also work as scheduled and endeavour to submit your assignment at the appropriate time.

### **Assessment**

The Assessment of your performance comprises of the Tutor-Marked Assignments (TMAs) and the End of Course Examinations.

### **Tutor-Marked Assignment (TMAs)**

There are five tutor-marked assignments. You will be required to submit all TMAs for grading. Every module in this course has a tutor-marked assignment for your assessment and the best three will be selected for the 30% part of the total assessment. The completed assessments and TMAs are expected to be sent to your tutor on or before the deadline for submission. In case you are unable to complete your assignments on time, contact your tutor to discuss the possibility of extension. It should be noted that extension will not be granted after due submission date, unless under unusual situation.

### **Final Examinations and Grading**

You shall be examined on all areas of this course in three hours duration examination. The final examination shall cover all the self-assessment questions for practice and the tutor-marked assignments given in this course. It is therefore worthwhile for you to revise the course material and the TMAs before the final examination. It is also advisable that you review all your tutor's comments on the TMAs before the final examination.

### Course Marking Scheme

The table below shows the breakdown of the total marks (100%) allocation:

Assignment	Marks
Assignments (best three assignments out of four that are marked)	30%
Final Examination	70%
<b>Total</b>	<b>100%</b>

### Course Overview

The table below indicates the number of units, number of weeks and assignments to successfully complete ECO 440

Units	Title of Work	Week's Activities	Assessment (end of unit)
	<b>Course Guide</b>		
<b>Module I An Overview of Fiscal Functions</b>			
1	The Allocation Function	Week 1	Assignment 1
2	The Distribution Function	Week 1	Assignment 1
3	The Stabilization Function	Week 2	Assignment 1
4	Co-ordination or Conflict of Functions	Week 2	Assignment 1
<b>Module 2 Public Revenue</b>			
1	Public Revenue: General Consideration	Week 3	Assignment 2
2	Taxation	Week 3	Assignment 2
3	Tax Assignment and Tax Shifting	Week 3	Assignment 2
4	Taxation and Fiscal Policy	Week 3	Assignment 2
<b>Module 3 Public Expenditure</b>			
1	Public Expenditure: General Consideration	Week 4	Assignment 3
2	Evaluation of Public Expenditure	Week 4	Assignment 3
3	Public Expenditure and Fiscal Policy	Week 4	Assignment 3
<b>Module 4 Economics of Public Debt</b>			
1	Introduction to Public Debt Economics	Week 5	Assignment 4
2	Public Debt and Budget	Week 5	Assignment 4
3	Debt Burden and Intergenerational Equity	Week 5	Assignment 4
<b>Module 5 Fiscal Federalism</b>			
1	Intergovernmental Fiscal Relations	Week 6	Assignment 5
2	Fiscal Federalism in Nigeria	Week 6	Assignment 5
3	Development Finance	Week 6	Assignment 5

### How to Get the Most from this Course

The study units in distance learning replace the conventional university lectures. Distance learning affords you an advantage of reading and working through specially designed study materials. It allows

you to study at your own pace, time and places that suites you. Accordingly, you would have to read the lectures instead of listening to a lecturer. The study units provide you with readings on the units as well as exercises to do at the end of each unit like a lecturer will give you some readings and assignments to do. It also consists of instructions on when to read each unit in the course material and when to do your assignments.

In each unit, there are set of learning objectives provided to assist you to know what you should be able to do or what you should know from each unit. These objectives should be your study guide such that at the end of completing each unit, you should check whether you have achieved the set objectives. This will largely increase your chance of passing the course. The main body of a unit will guide you through the required reading from other sources such as your textbook or course guide. Genuine plan of working through the course is to phone or email your tutor if you have any trouble with any unit or need any assistance. Furthermore, carefully follow the following advice:

- (i) Read the course guide thoroughly and with necessary care.
- (ii) Arrange a study strategy using the Course Overview in the Course Guide. The expected time to spend on each unit and the assignment related to it should be well noted. You can as well write out your own dates for working on each unit according to your study plan.
- (iii) Draw-up a study plan and stick to it. If you have any difficulty in your study plan, try informing your tutor before it is late. Student usually failed because they are lagging behind in their course work.
- (iv) Read each unit carefully including their introduction and the objectives.
- (v) Information about requirements on each unit is given in the “Overview” at the beginning of each unit.
- (vi) The contents of each unit are presented in such a way that it provides you with a sequential order to follow. Therefore, use each unit to guide your readings. You may be required to read sections from more than one references beside the Course Material.
- (vii) Always review the objectives of each unit to know if you have achieved them or not. If you are uncertain of your understanding of the issues addressed in any unit after reviewing the objectives, consult your tutor.
- (viii) You can move to the next unit when you are pleased with your reading in the previous unit.
- (ix) After submission of an assignment, do not wait for your marks before you proceed to the next unit in order to keep to your study plan. Contact your tutor as soon as possible for any question, clarification or observation.
- (x) Any new information about the course will be communicated at your study centre.
- (xi) Prepare for the final examination after completing the whole units of the course. Ensure you achieved the listed course and units’ objectives.

### **Tutors and Tutorials**

There are 2-hours session of tutorial provided in support of this course. The allocated dates, time and location of tutorial, including your tutor’s name, phone number and e-mail address will be communicated to you at the right time. Your completed and submitted assignment shall be marked by your tutor and your grade will be sent to you online. For this reason, you are to monitor your progress closely as your tutor is doing. When any difficulty arises in the course, your tutor should be ready to assist. Ensure you email your tutor-marked assignment to your tutor before the deadline. It would be marked by your tutor and your marks will be e-mail and text to you. As mentioned earlier, free to contact your tutor by e-mail, phone or through your discussion group whenever the need arises. For instance, you may contact your tutor under the following circumstances:

- (i) If you don’t understand any part of the study units or the assigned readings

- (ii) If you have any problem answering the self-assessment questions.
- (iii) If you have question(s) or clarification(s) on your assignment, your tutor's comments on the assignment and TMAs or with your grading.

Ensure to attend all tutorials to have the opportunity of face-to-face interaction with your tutor. Any problem faced in your course of study could be raised, and everyone in your class could benefit from participating in active discussions and in asking questions you prepared before attending the tutorials.

### **Summary**

Taxation and Fiscal Policy (ECO 440) provides you with the knowledge and understanding of how government implements her taxation and fiscal policy and the effects of this policy on the individual economic agents and the whole economy at large. The course further examines the sources and nature of government debts and the implications of government debts on current and future generations. The course guide provides you with an overview of what you should expect in the course of study.

<b>Module One</b>	<b>An Overview of Fiscal Functions</b>
Unit 1	The Allocation Function
Unit 2	The Distribution Function
Unit 3	The Stabilization Function
Unit 4	Co-ordination or Conflict of Functions

## **UNIT 1 The Allocation Function**

### **CONTENTS**

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### **1.0 INTRODUCTION**

This module gives the general background to the fiscal problem, thus taking a comprehensive view of the issues considered in this course. Fiscal policy plays an important role in influencing the economic direction of any country. When speaking of fiscal policy, this is generally referred to as two major governmental economic activities, taxation and expenditure. The national budget is the major fiscal instrument by which the federal government determines how much of its resources to devote to these two major activities.

The development of a fiscal policy generally has four primary functions vis allocation, stabilization, distribution and development. The need for fiscal measures is determined by how the private sector would perform in their absence. This course examines the taxation (revenue) and expenditure measures of the public sector. This module is important to the understanding of all other modules, because other modules will be discussed on the basis of the issues addressed here. This module starts with the allocation function and the proposition that certain goods -referred as public and social goods as distinct from private goods-cannot be provided for through the market system.

There are cases in which the wants of all individuals cannot be satisfied through market mechanism. In such cases the public sector or the governments have to provide goods and services. The allocation branch of public finance deals with the provision of social goods. Social goods are those goods and services produced to satisfy collective wants. Collective wants are those wants which are demanded by all members of the community. The allocation branch explains the process by which the resources are divided between private goods and social goods by which the mix of social good is chosen.

### **2.0 OBJECTIVES**

At the end of this unit, students should be able to:

- (i) Understand the need for public sector
- (ii) Define public and social goods
- (iii) Understand market failure and the possible cause of market failure
- (iv) Understand how funds allocation is related to taxation and spending
- (v) The direct economic impact of government allocation function in the country

### **3.0 MAIN CONTENT**

#### **3.1 The Need for Public Sector**

The modern economy is a mixed system in which public and private sectors forces interact together. The economic system is neither public nor private, but involves a mix of both sectors. The government sector is the public sector of the economy. It is the part of the economy concerned with providing various governmental services. The composition of the public sector varies by country, but in most countries the public sector includes such services such as the military, infrastructure such as public roads, bridges, water supply, public education, along with health care for the poor and those working for the government itself such as elected officers. The public sector might provide services that a non-payer cannot be excluded from (e.g. street lighting), which benefit all the society rather than just the individual who uses the service.

The market mechanism alone cannot perform all economic functions. Public policy is required to regulate, guide and correct the working of the economy in certain aspects. The major function of the public sector is the use of tax and expenditure policy to regulate the economy. Tax and expenditure measures may affect the economy in many ways and may be designed to serve a variety of purposes.

From the normative view one may asked why is it that a public sector is required? Or putting it differently, why is it that in a private enterprise economy, a considerable part of the economy is subject to some form of government direction, rather than left to the "invisible hand" of market forces?

The answer to this question may starts from the generally accepted premises in the society, that the entire economy may not be left to the private sector because (i) the composition of output should be in line with the preferences of individual consumers and that (ii) there is a preference for decentralized decision making. The presence of government may partly reflect the presence of political and social ideologies that depart from the premises of consumer choice and decentralized decision making.

More importantly, there is a fact that market mechanism alone cannot perform all economic functions. Therefore, public sector is needed to regulate and correct the activities of private sector in certain respects. It is therefore important to understand this fact since it implies that the proper size of the public sector is, to a significant degree, a technical rather than an ideological issue.

Therefore, public intervention is required in the economic activities for the following reasons:

- (i) The claim that the market mechanism leads to efficient resource use (i.e. produces what consumers want most and does so in the cheapest way) is based on the condition of competitive factor and product markets. This means that there must be no obstacles to free entry and those consumers and producers must have full market knowledge. Government regulation or other measures are required to secure these conditions.
- (ii) Public sector is needed where, due to decreasing cost, competition is inefficient.
- (iii) Also, the contractual arrangements and exchanges needed for market operation cannot exist

- without the protection and enforcement of a government provided legal structure.
- (iv) The production or consumption characteristics of certain goods are such that these goods cannot be provided for through the market due to the problems of "externalities" and "market failure" which require solution through the public sector.
  - (v) Social values may also require adjustments in the distribution of income and wealth which results from the market system and from the transmission of property rights through inheritance.
  - (vi) The market system, especially in a highly developed financial economy, does not necessarily bring high employment, price level stability and the socially desired rate of economic growth, hence; public policy is needed to achieve these objectives.
  - (vii) The rate of discount used in the valuing of future (relative to present) consumption may differ as seen from a public and a private point of view.

Given that the above-mentioned limitations of the market mechanism required corrective measures of public policy, does not provide enough evidence that any policy measure undertaken will improve the performance of the economic system. Public policy, like private policy can also be inefficient and the main purpose of our study of taxation and fiscal policy is that of exploring how the effectiveness of policy formulation and application can be improved.

### **SELF ASSESSMENT EXERCISE**

Externality and market failure are mentioned as part of the reasons for the need for the intervention of public sector in the economy. From your knowledge of public finance what are the main causes of externality and market failure and how can these be corrected?

### **3.2 Public Goods and Market Failure**

In economics a public good is a good that is both non-excludable and non-rivalrous in that individuals cannot be effectively excluded from consuming and in which use by one individual does not reduce availability to others. The defining characteristic of a public good is that consumption of it by one individual does not reduce the amount available to be consumed by another individual. In a non-economic sense, the term is used to describe something that is useful for the public generally, such as education and infrastructure, although these are not "public goods" in the economic sense.

Public goods include fresh air, knowledge official statistics, national security, common language(s), flood control systems, lighthouses, and street lighting. Many public goods may at times be subject to excessive use resulting in negative externalities affecting all users; for example air pollution and traffic congestion. Public goods problems are often closely related to the "free-rider" problem, in which people not paying for the good may continue to access it. Thus, the good may be under-produced, overused or degraded. Public goods may also become subject to restrictions on access and may then be considered to be club goods or private goods.

Technological progress can create new public goods. The simplest examples are street lights. One person's enjoyment of them does not detract from other persons' enjoyment, and it would be prohibitively expensive to charge individuals separately for the amount of light they presumably use. Official statistics are another example. The government's ability to collect, process and provide high-quality information to guide decision-making at all levels has been strongly advanced by technological progress.

The opposite of a public good is a private good, which does not possess these properties. A loaf of bread, for example, is a private good; its owner can exclude others from using it, and once it has been consumed, it cannot be used again. A good that is rivalrous but non-excludable is sometimes called

a common-pool resource. The figure 1-1 below shows classification of goods into public goods, private goods, common-pool resources and club goods.

Rivalrous	Private goods food, clothing, cars, parking spaces	Common-pool resources fish stocks, timber, coal
Non-Rivalrous	Club goods cinemas, private parks, satellite television	Public goods free-to-air television, air, national defense

Social goods are defined as public goods that could be delivered as private goods, but are usually delivered by the government for various reasons, including social policy, and funded via public funds like taxes. Social good or service is a good that benefits the largest number of people in the largest possible way. Some good examples of social goods are clean air, clean water and literacy. In addition, many economic advocates include access to services such as healthcare in the definition of the social good.

The basic reason for market failure in the provision of public and social goods is that the benefits to which these goods give rise are not limited to one consumer who purchases the goods, as is the case for private goods, but become available to others as well. Public goods provide an important example of market failure, in which market-like behaviour of individual gain-seeking does not produce efficient results.

The production of public goods results in positive externalities which are not remunerated. If private organizations do not reap all the benefits of a public good which they have produced, their incentives to produce it voluntarily might be insufficient. Consumers can take advantage of public goods without contributing sufficiently to their creation. This is called the free rider problem (because consumers' contributions will be small but non-zero). If too many consumers decide to "free-ride", private costs will exceed private benefits and the incentive to provide the good or service through the market disappears. The market thus fails to provide a good or service for which there is a need.

If an individual consumes a tube of yam or wear pair of shoes, these particular products will not be available to other individuals. Individuals consumption stand in a rival relationship. This is the situation with private goods. But now consider measures to reduce air pollution. If a given air quality improvement is obtained, the resulting gain will be available to all who breathe. In other words, consumption of such products by various individuals is "non-rival" in the sense that one person's partaking of benefits does not reduce the benefits available to others, to put it differently, the benefits derived by anyone's consuming a social good are "externalized" in that they become available to all others. This is the situation with public and social goods. In the case of private goods, the benefits of consumption are "internalized" with a particular consumer whose consumption excludes consumption by others.

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. In fact, the market system may be viewed as a giant auction where consumers bid for products and producers sell to the highest bidders. Thus, the market furnishes a signaling system whereby producers are guided by consumer demands. For goods such as yam or pairs of shoes this is an efficient

mechanism. Nothing is lost and much is gained when consumers are excluded unless they pay.

Application of the exclusion principle tends to be an efficient solution for private goods. But not so in the case of public and social goods because it would be inefficient to exclude any consumer from partaking in the benefits. When such participation would not reduce consumption by anyone else. The application of exclusion would thus be undesirable, even if it were readily feasible. Furthermore, the application of exclusion is frequently impossible or prohibitively expensive. Gains from air-cleaning measures cannot readily be withheld from particular consumers. Streetlights shine upon all who pass by, and so forth. Given these conditions, the benefits from public and social goods are not vested in the property rights of certain individuals, and the market cannot function.

But where the benefits are available to all, consumers will not voluntarily offer payments to the suppliers of public and social goods. Individuals will benefit as much from the consumption of others and with thousands or millions of other consumers present. Individuals payment is only an insignificant part of the total. 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.

### **SELF ASSESSMENT EXERCISE**

Articulate the basic reasons for market failure in the provision of public goods.

### **3.3 Public Provision of Public Goods**

Since the provision of public good cannot be left to private sector, then government has to determine how much of such goods is to be provided. But the difficulty lies in deciding the type and quality of a public good that should be supplied and how much a particular consumer should be asked to pay. Political process and societal preferences and needs are mostly employed for determine the quantity and quality of public goods to produced. This however, does not usually produce an efficient result.

Just as individual consumers have no reason to offer voluntary payments to the private producer, they also have no reason to reveal to the government how they value the public service. Consumers have no reason to declare what the service is truly worth to them individually unless they are assured that others will do the same. Placing tax contributions on a voluntary basis would, therefore, be to no avail. People will prefer to enjoy as "free riders" what is provided by others. Therefore, a different technique is needed by which the supply of public goods and the cost allocation thereof can be determined. This is where the political process enters the picture as a substitute for the market mechanism. It may be reasonable to rule that the individual should pay for the benefits received, as in the case of private goods, but this does not solve the problem; the fundamental difficulty lies in how these benefits are valued by the recipient.

### **SELF ASSESSMENT EXERCISE**

What are the technique of determining the supply of public goods and the cost of public goods.

### **3.3 Public Provision versus Public Production**

Before considering how public provision of public good is to be arranged, a clear distinction must be drawn between public provisions for public goods and public production. These are two distinct and indeed unrelated concepts which should not be confused with each other.

Private goods may be produced and sold to private buyers either by private firms as normally done or by public enterprises, such as public power and transportation authorities. Pubic goods, such as health care and military hardware may be produced by private firms and sold to government: or they may be

produced directly under public management as services rendered by civil servants or municipal enterprises. If we say that public goods are provided publicly, we mean that they are financed through the budget and made available free of direct charge. How they are produced does not matter.

In the allocation function of public sector two major issues are to be noted:

- (i) It is unrealistic to think of all goods as being divided into those which are private and those which are public or social. The existence of externalities and the public-goods problems to which they give rise are a matter of degree, and many goods carry both characteristics. Education, for instance, will benefit not the individual that acquired it but also others.
- (ii) In some instances, government decides to interfere with consumer preferences. Certain goods may be considered meritorious (education) whereas others are considered harmful (cigarette) so that one is subsidized while the other is taxed.

Finally, whether the goods and services are purchased privately or provided through the budget (corresponding to the distinction between private and social goods), and whether they are produced publicly or by private firms, public goods constitute a large part of total output in any country; and public production exists for the provision of public goods. Public enterprise is much larger in the socialist economies such as the former U.S.S.R., where the bulk of production is by public enterprise. But the share of total output going into public goods differs much less. It is thus evident that the decision whether to allocate resources to social goods or to private goods is quite different from that to produce any good (private or social) in a public or a private enterprise. A socialist economy in which most production is public may produce largely private goods while a capitalist economy where all production is private may produce a larger share of public goods. In fact, provision for public goods poses much the same problem in the capitalist (private firm) as in the socialist (public enterprise) setting. In both cases, it is difficult to determine how such goods are valued by consumers. At the same time provision for public goods requires taxation. This may interfere with incentives and may be more damaging in the capitalist than in the socialist setting.

### **SELF ASSESSMENT EXERCISE**

Discuss the problems that are likely to be faced in the provision of public goods under both socialist and capitalist economic system.

### **4.0 Conclusion**

From our discussion so far on public sector allocation function, we have been able to identify that:

- That limitations of the market mechanism to sometime failed to allocate resources efficiently necessitates the need for public sector intervention.
- Public sector, like private sector can also be inefficient in the resource allocation.
- The main purpose of the study of taxation and fiscal policy to explore how the effectiveness of policy formulation and application can be improved.
- Public good, externality and market failure are among the factors that led to the failure of market system to allocate resource efficiently.
- Application of the exclusion principle tends to be an inefficient solution in the provision of public good; hence it's difficult to charge for the consumption of public good.
- Since the provision of public good cannot be left to private sector, government has to determine how much of such goods is produced which usually determined through political process.
- Public goods constitute a large part of total output in any country.

### **5.0 Summary**

This unit has simply introduced us to the importance and the need for public sector intervention in the economic activities in any economy. It further exposes the need for the allocation function of the public sector. The failure of market mechanism to efficiently allocate resource due to market failure as a result of the existence of externality, market power and public good was also looked into. A brief discussion of the difference between public good and private good was also undertaken. Failure of the government to also failed to allocate resource efficiently was as well discussed. All these are expected to have provided a good foundation for the task ahead in this course.

### **6.0 Tutor-Marked Assignment**

Like private sector, public sector can as well fail to produce efficient results in their allocation function, submit a two-page essay on the factors that may lead to the failure of government to allocate resources efficiently.

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## **UNIT 2 The Distribution Function**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 Determinants of Distribution
  - 3.2 Optimal Distribution
  - 3.3 Fiscal Instruments of Distribution Policy
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

### **1.0 INTRODUCTION**

The allocation function of securing an efficient provision of social goods poses the type of problem with which economic analysis has traditionally been concerned, but the problem of distribution is more difficult to handle. The important feature of a market economy is the disparity in the distribution of income and wealth. The distribution function of public finance deals with the adjustment of the distribution of wealth and income to ensure “fair or just” state of distribution. That is, the distribution function of public finance deals with the determination of taxes and transfer payments policies of the governments. Distribution issues are frequently a major point of controversy in the determination of public policy. In particular they play a key role in determining tax and transfer policies,

### **2.0 OBJECTIVES**

- (i) Understand the determinants of income and wealth in a country
- (ii) Understand optimal distribution of State resources
- (iii) Understand fiscal instruments of distribution policy
- (iv) Understand the economic impact of government distribution function in the country

### **3.0 MAIN CONTENT**

#### **3.1 DETERMINANTS OF DISTRIBUTION**

In the absence of policy measures to adjust the prevailing state of distribution, the distribution of income and wealth depends first of all on the distribution of factor of production endowments. Earnings abilities differ as does the ownership of inherited Wealth. The distribution of income, based on this distribution of factor endowments is determined by the process of factor pricing, which, in a competitive market, sets factor returns equal to the value of the marginal product. The distribution of income among individuals thus

depends on their factor supplies and the prices in the market. The distribution of income within a society may be represented by the Lorenz curve. The Lorenz curve is closely associated with measures of income inequality, such as the Gini coefficient.

This distribution of income may or may not be in line with what society considers fair or just. Therefore, a distinction must be drawn between:

- (i) the principle that efficient factor use requires factor inputs to be valued in line with competitive factor pricing,
- (ii) the proposition that the distribution of income among families should be fixed by the market forces.

The first principle is an economic rule that must be observed if there is to be efficient use of resources. But the second proposition is a different matter because factor prices as determined in the market may not correspond with the competitive standard. Even if all factor prices, including wages and other returns to personal services were determined competitively, the resulting pattern of distribution might not be acceptable to the society. It may involve a large degree of inequality especially in the distribution of capital income. Though views on distributive justice differ, most would agree that adjustments are required for fair and equal distribution to occur. From the above, it can be deduced that the determinants of the distribution of income and wealth include:

- (i) factors contribution to production process
- (ii) the market value of factors product
- (iii) natural endowments
- (iv) inheritance
- (v) societal preferences
- (vi) Political Preferences
- (vii) Tax policies and other economic policies
- (viii) Labour union policies
- (ix) The market for labour
- (x) Individuals abilities
- (xi) Abilities
- (xii) Worker education, globalization, gender, race and culture.

### **SELF ASSESSMENT EXERCISE**

Why is market determined income distribution may at times not be acceptable to society?

### **3.2 OPTIMAL DISTRIBUTION**

Given that a market determined distribution may not be acceptable to the society; then it is important to consider what constitutes a fair or just state of distribution. Modern economic analysis has shy away from this problem. The core of modern welfare economics has been to define economic efficiency in terms that exclude distributional considerations. A change in economic conditions is said to be efficient (i.e., to improve welfare) if, and only if the position of some person say; *A* is improved without that of anyone else; including *B* and *C* being worsened. This is referred to as pareto optimality in the modern welfare economics. This criterion which may be qualified and amended in various ways cannot be applied to a redistribution measure which by definition improves *A*'s position at the expense of *B*' and *C*'s.

While pareto optimality rule (i.e. "someone gains; No one loses" rule) has served well in assessing the efficiency of markets and of certain aspects of public policy, it contributes little to solving the basic social issues of distribution and redistribution. Therefore, the answer to the question of fair distribution involves considerations of social philosophy and value judgment.

Philosophers have provided variety of answers, including the view that persons have the right to the fruits derived from their particular endowments that distribution should be arranged so as to maximize total happiness or satisfaction, and that distribution should meet certain standards of equity, which in a limiting case may be egalitarian. The choice among these criteria is not simple, nor is it easy to translate anyone criterion into the corresponding "correct" pattern of distribution. This difficulty occurs when dealing with redistribution policy and in interpreting the widely accepted proposition that people should be taxed in line with their "ability to pay."

There are two major problems involved in achieving equity in income distribution. Firstly, it is difficult or impossible to compare the levels of utility which various individuals derive from their income. There is no simple way of adding up utilities, so that criteria based on such comparisons are not operational. This limitation has led people to think in terms of social evaluation rather than subjective utility measurement. The other difficulty arises from the fact that the size of the pie which is available for distribution is not unrelated to how it is to be distributed. This mean that redistribution policies may involve an efficiency cost which must be taken into account when one is deciding on the extent to which equity objectives should be pursued.

Nonetheless these difficulties; however, distributional considerations have remained an important issue of public policy. Attention appears to be shifting from the traditional concern with relative income positions, with the overall state of equality, and with excessive income at the top of the scale, to adequacy of income at the lower end. Thus, the current discussion emphasizes prevention of poverty, setting what is considered a tolerable cutoff line or floor at the lower end rather than putting a ceiling at the top.

### **SELF ASSESSMENT EXERCISE**

What are the major difficulties encountered in achieving an optimal income distribution?

### **3.3 FISCAL INSTRUMENTS OF DISTRIBUTION POLICY**

Redistribution is implemented mostly by:

- (i) a tax-transfer scheme, combining progressive income taxation of high income households with a subsidy to low-income households.
- (ii) progressive income taxes used to finance public services, particularly those such as public housing, which
- (iii) redistribution may be achieved by a combination of taxes on goods purchased largely by high-income consumers with subsidies to other goods which are used mostly by low- income consumers.

However, in choosing among alternative policy instruments, allowance must be made for resulting "deadweight losses" or efficiency costs, i.e., costs which arise as consumer or producer choices are interfered with. Redistribution via an income tax-transfer mechanism has the advantage that it does not interfere with particular consumption or production choices. Yet, this mechanism is not without its "efficiency cost" since the choice between income and leisure remains affected. Nevertheless, the distortion is likely to be less than with more selective measures, so that, the function of the distribution branch may be regarded as being discharged by a set of direct income taxes and transfers.

Where redistribution involves an efficiency cost, this consequence by itself establishes no conclusive case against such policies. It merely tells us that:

- (i) any given distributional change should be accomplished at least efficiency cost

- (ii) that a need exists for balancing conflicting policy objectives.
- (iii) Efficiency in the broad sense, i.e., an optimally conducted policy must be allow for both concerns.

### **SELF ASSESSMENT EXERCISE**

What are the main tools of redistribution? And what are issues surrounding the use of each of this tool?

#### **4.0 Conclusion**

From our discussion on the distribution function, we have been able to identified that:

- Market mechanism may not be capable of achieving optimal distribution of resources because societal preferences may be different from market preferences.
- There are many factors to be considered in distributing societal resources which may include societal culture, political preferences etc.
- Tax and income-transfer policies are the main tools of government distribution policy.
- The pattern of distribution which results from the existing pattern of factor endowments and from the sale of factor services in the market is not necessarily one which society considers as fair. Distributional adjustments may be called for and tax and transfer policies offer an effective means of implementing them. Thus, calling for a distribution function in budget policy.

#### **5.0 Summary**

This unit has simply introduced us to another important reason for the public-sector intervention in the economic activities in any economy. It exposes the need for the distribution function of the public sector as a result of the conflicting preferences of market mechanism and society. The reason for public intervention in the distribution of societal resources was considered. A discussion of the tools of distribution policy of the public sector was undertaken. A trade-off between equity and efficiency was also discussed. All these are expected to further provide a good foundation for the task ahead in this course.

#### **6.0 Tutor-Marked Assignment**

Public sector intervenes in the distribution function due to the inequality that may occur if the distribution function is left for the market forces alone. Submit a two-page essay on the impact of public spending, education, and institutions on income distribution in the developing economies.

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## **UNIT 3 The Stabilization Function**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 The Need for Stabilization
  - 3.2 Fiscal and Monetary Instruments of Stabilization Policy
  - 3.3 Policy Mix
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

### **1.0 Introduction**

Having dealt with the budget policy on matters of allocation and distribution, we now examine its role as an instrument of macroeconomic policy. Fiscal policy must be designed to maintain or achieve the goals of high employment. The stabilization function explains the macroeconomic aspect of budgetary policy. In other words, the stabilization function deals with the use of budgetary policy as a means of maintaining high employment, a reasonable degree of price stability and an appropriate rate of economic growth, with allowances for effects on trade and balance of payments. The major instruments of stabilization policy are monetary policy and fiscal policy. This function is also known as compensatory finance.

### **2.0 Objectives**

- (i) Understand the purpose of stabilization
- (ii) Understand the instruments of stabilization policy
- (iii) Understand the policy mix
- (iv) Understand how policy can be shaped effectively.

### **3.0 Main Content**

#### **3.1 THE NEED FOR STABILIZATION**

Full employment and price stability do not occur automatically in a market economy but require public

policy guidance. Therefore, fiscal policy is required for stabilization. Without it the economy may be subject to substantial fluctuations which may result into a sustained period of unemployment or inflation. To make matters worse, unemployment and inflation may exist at the same time. To assume that public policy is needed to deal with these contingencies does not prevent the possibility that public policy may itself be a destabilizer if poorly conducted.

The overall level of employment and prices in the economy depends upon the level of aggregate demand, relative to potential or capacity output valued at prevailing prices. The level of demand is a function of the spending decisions of millions of consumers, corporate managers, financial investors and unincorporated operators. These decisions in turn depend on many factors such as past and present income, wealth position, credit availability and expectations. In any period, the level of expenditures may be insufficient to guarantee full employment of economic resources.

Since wages and prices are downward rigid and for other reasons there is no ready mechanism by which such employment will restore itself automatically. Expansionary measures to raise aggregate demand are needed. At other times, expenditures may exceed the available output under conditions of high employment and thus may cause inflation. In such situations, restrictive conditions are needed to reduce demand. Furthermore, just as deficient demand may generate further deficiency, an increase in prices may also generate further expectation of price rise, leading to renewed inflation. In neither case there is an adjustment process by which the economy is automatically returned to high employment and stability.

This task is complicated by the fact that economies do not operate in isolation but are linked to one another by trade and capital flows. Policies which affect the level of domestic income and prices also affect a country's exports imports and balance of payments. This in turn affects the economic position of other countries. Stabilization policy thus must be conducted in a way which involves the complex problems of international policy coordination. Whereas, in the thirties and forties the problem of stabilization was seen as one of reaching full employment within a given level of potential output, developments since the fifties have shifted attention to the rate of growth of potential output and inflation. Given the rate of increase in population and/or productivity, the level of aggregate expenditures must be adjusted to rise, so as to permit demand to expand in line with potential output. This objective will require periodic adjustments in fiscal policy. Also, public policy may not accept the rate of growth of potential output as determined by market forces but may wish to influence this rate. Since growth depends among other things upon the rate of capital formation, the rate of saving and investment incentives become a strategic importance.

More recently, primary focus has been on inflation. After a high level of employment was reached in the mid-sixties, the problem became one of restraining inflation without losing the full-employment objective. As shown in the seventies, policy may have to fight inflation and unemployment simultaneously.

### **SELF ASSESSMENT EXERCISE**

Explain the main reasons for the need for stabilization policy.

### **3.2 FISCAL AND MONETARY INSTRUMENTS OF STABILIZATION POLICY**

The existence of the fiscal system has an immediate and inevitable influence on the level and structure of demand. Even if fiscal policy was intended to be neutral, it would be necessary to consider effects on aggregate demand to guarantee such neutrality. Moreover, changes in budget policy may be used as a positive means of obtaining or offsetting changes in demand.

**The Leverage Effects of Given Budget:** Government expenditures add to total (private plus public) demand, while taxes reduce it. This suggests that budgetary effects on demand will be substantial, if the level of expenditures is high and the tax revenue is low. Deficits are expansionary and surpluses are restrictive, but even a balanced budget has an expansionary effect.

**Changes in Budget Policy:** Discretionary policy measures may be taken to affect the level of aggregate demand. The government may raise its expenditures or reduce tax rates if demand is to be expanded and vice versa if it is to be contracted. Depending on the type of expenditure or tax adjustments made, consumption or investment in the private sector may be affected and the promptness of the expenditure response may differ. Therefore, the policy problem is not only one of direction of change but also of selecting the proper type and magnitude of change.

**Built-in Responses:** Changes in the level of public expenditures or tax rates are used to affect the overall level of demand and changes in the level of economic activity will also affect public expenditures and tax revenue. Thus, the level of expenditure under any given programme may vary with economic activity in the case of unemployment benefits and welfare. More important, the revenue obtained from given tax rates will rise or fall with changes in the level of income or sales subject to tax. Thus, the fiscal system possesses a built-in flexibility which responds to changes in the economic scene.

**Monetary Instruments:** While the market mechanism may be relied upon to determine the allocation of resources among private goods if it functions well, economists agree that it cannot by itself regulate the proper money supply. As Walter Bagehot pointed out a century ago, "Money does not control itself." The banking system if left to its own devices will not generate just that money supply which is compatible with economic stability, but will (in response to the credit demands of the market) intensify prevailing tendencies to fluctuation. Therefore, the money supply must be controlled by the central banking system and be adjusted to the needs of the economy in terms of both short-run stability and long-run growth. Monetary policy (including the devices of reserve requirements, discount rates, open market policy and selective credit controls) is thus an indispensable component of stabilization policy.

### **SELF ASSESSMENT EXERCISE**

Discuss the different instruments of stabilization policy and how they operate in the macroeconomy.

### **3.3 POLICY MIX**

Policy mix refers to the combination of fiscal and monetary policy to achieve one or more objectives. Although monetary and fiscal measures supplement each other they differ in their impact. By using them in proper combination, it is possible to achieve more objectives than would be possible with the use of one policy instrument alone. Thus, a mix of easy money (permitting high expenditures, particularly investment) and a tight budget (reducing the level of aggregate expenditures, particularly consumption) is favourable to economic growth.

Given fixed exchange rates, monetary policy has a special advantage (due to its effects on international capital movements) in securing balance of payments adjustments, while fiscal policy is more effective in dealing with domestic needs. Monetary and fiscal policies are therefore linked by the need for obtaining a policy mix which will permit the pursuit of multiple policy objectives. Moreover, there is a mechanical link between fiscal and monetary measures while budgetary imbalance (surplus or deficit, depending on the needs of the situation) is an important tool of fiscal policy. This means that the structure of claims including money and public debt is changed in the process. These "claim effects" are an inevitable by-product of budgetary imbalance, providing an important link between fiscal and monetary policy.

Fiscal and monetary policies thus interact and complement each other in important ways, but they also

suffer from the same weakness. So long as the problems of unemployment and inflation are merely due to a deficiency or excess of aggregate demand, measures aimed at controlling aggregate demand are likely to be effective. But they become less so in dealing with stagflation, where structural maladjustments in various markets are at the root of the problem.

### **SELF ASSESSMENT EXERCISE**

Describe policy mix and its effectiveness in achieving stabilization objectives.

### **4.0 Conclusion**

From our discussion of the stabilization function, we have been able to identify that:

- Full employment and price stability do not occur automatically in a market economy but require public policy guidance
- The existence of the fiscal system has an immediate and inevitable influence on the level and structure of demand
- Monetary and fiscal measures differ in their impact, yet they can supplement each other by using them in proper combination to achieve more objectives than would be possible with the use of one policy instrument alone. Hence, the need for policy mix.
- Theoretically budget policies can be designed so that allocation, distribution and stabilization objectives are accomplished without conflict. But In practice, conflicts are frequent and distortions arise.

### **5.0 Summary**

This unit exposes us to the stabilization function of the public sector. The tools of stabilization policy were considered and how they were considered. Also, the reasons and how the mixture of fiscal and monetary policy can be employed to achieve more than one stabilization objectives was discussed. Different tools of stabilization policy were also looked into. All these are also expected to provide a good foundation in this course.

### **6.0 Tutor-Marked Assignment**

Write a two-page essay on policy mix and how it can be used to achieve one or more stabilization objectives.

### **7.0 References/Further Reading**

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## **UNIT 4 The Coordination or Conflict of Functions**

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- 2.0 Objectives
- 3.0 Main Content
  - 3.1 Coordination
  - 3.2 Conflict
  - 3.3 Interaction of Private and Public Sectors
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
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### **1.0 INTRODUCTION**

Having considered the three main functions of the public sector in the economy, it remains to consider how the three basic functions of fiscal policy-allocation, distribution and stabilization- are coordinated into an overall pattern of budget policy. The distinction between a normative and a descriptive (or predictive) view of the fiscal process must be kept in mind here. Although fully coordinated policy determination permits simultaneous achievement of the various objectives, actual practice gives rise to multiple conflicts.

### **2.0 Objectives**

- (i) Understand the coordinated approach under a normative conducted fiscal process
- (ii) Understand how conflicts occur and coordinated in fiscal process
- (iii) Understand that budget policies can be designed so that allocation, distribution and stabilization objectives are accomplished without conflict.
- (iv) Understand that the functions of the public and private sector- differ in important respects, but the operations of both interact in the product and factor markets as well as in the income and expenditure flows of the economy.

### **3.0 Main Content**

#### **3.1 COORDINATION**

In dealing with the analysis of public policy, economists have shown that the number of available policy tools must match the number of policy targets. If the tools are insufficient, a conflict among targets must be expected. Given the three targets of allocation, distribution and stabilization thus:

- (i) provision for social goods,
- (ii) adjustments in distribution
- (iii) stabilization

Three policy instruments are required to meet the listed items. Think of them as three separate sub-budgets or fiscal branches, each designed for the implementation of its particular objective. The administrator of the distribution-branch budget will design a tax-transfer plan to secure the desired adjustment in distribution. A full-employment level of income will be assumed for this purpose. It may also be assumed that the allocation branch provides for public services financed by taxes imposed in line with consumer evaluation. The sub-budget of the "distribution branch, by its very nature, will be balanced. The administrator of the allocation branch in turn will provide for social goods and finance them by taxes imposed in line with consumer evaluation. In so doing this administrator will assume that the distribution branch has secured the "proper" state of income distribution and that the stabilization branch has secured full employment. This will again involve a balanced budget.' The administrator of the stabilization branch finally will provide for the necessary adjustment in aggregate demand. Also, proceeding on the assumption that the other two branches have met their tasks. By its nature this final budget will consist of either taxes or transfers and usually be in imbalance. Taxes and transfers used to accomplish the stabilization task may be designed so as not to interfere with the "proper" distribution as provided by the distribution branch, i.e., they will be proportional to the "proper" pattern of income distribution.

We may wonder how this can be done, since the respective plans of the three branches are closely interdependent. The answer is that the system may be solved by simultaneous determination." When the three budgets have been determined in this fashion, it would then be difficult for administrative purpose, to carry out each budget separately. Rather, it will be convenient to clear the taxes imposed by the allocation branch, the taxes and transfers of the distribution branch and the taxes and transfers of the stabilization branch against each other and implement only the resulting net transfer and taxes with regard to each consumer. Government must also undertake the purchases of products or resources needed to provide for the services of the allocation branch in addition to these net taxes and transfers.

The combined or net budget may thus be viewed as a composite of the three sub-budgets. It will have a deficit or surplus. Depending on the position of the stabilization branch. Whether the net payment system will be progressive, proportional or regressive is not clear. The distribution branch component would tend to make it progressive but it remains to be seen how the allocation component will appear.

This system has been spelled out not as a description of the budget process, but to show how the various objectives could be coordinated and pursued without interference with one another.

#### **SELF ASSESSMENT EXERCISE**

Explain why the number of available policy tools must match the number of policy targets in the analysis of public policy.

### 3.2 CONFLICT

The distinction among the allocation, distribution, and stabilization aspects of fiscal policy is helpful not only in separating distinct policy objectives but also as a guide to fiscal politics. Budget planning does not permit evaluation of the various policy objectives on their own merits in the real-world setting. Individual and group interests clash in their implementation so that achievement of one objective is frequently accomplished at the cost of another.

**Allocation and Distribution:** Considering the relationship between allocation and redistribution measures, although redistribution is accomplished most directly through tax-transfer schemes, it is also achieved by progressive tax finance of the provision for social goods. This is based on an "ability to pay approach," by which the distribution of the tax burden is determined by the ability of a taxpayer to bear the sacrifice of income reduction, independent of the tax of social goods which is supplied and the benefits derived from it. Because of this, the degree of redistribution tends to depend on the levels of programmes to be financed, thus associating extensive provision for social goods with extensive redistribution.

This approach broadened the cause of redistribution when budgets were small and the addition burden could be imposed on high-income recipients. But over time as budgets increased relative to national income, additional finance had to be drawn larger from the middle- and low-income groups, thus reversing this effect. In either case, the linkage between expenditure levels and redistribution does not make for efficiency from a normative point of view. People's attitudes toward redistribution need not coincide with their preferences for social goods. A person who wants public services should not have to oppose them because he or she dislikes redistribution or vice versa, a better policy choice will be made, if each issue is taken up on its merits.

**Allocation and Stabilization:** We now consider the relationship between considerations of allocation and stabilization. In unemployment period, when an expansion of aggregate demand is needed, an increase in government expenditures is often proposed as a solution. Similarly, during inflation, when demand is to be restricted, a case is made for a reduction in such expenditure. While it is proper for social goods to share in a general expansion or restriction of expenditures, there is no reason why they should account for the entire or major part of the change. The stabilizing adjustment can also be made through increase or reduction in taxes, or reduction or increase in transfers, while leaving the provision for social goods (appropriate at full-employment income levels) unaffected.

Mixing the issues leads to an oversupply of social goods or to wasteful public expenditures when expansion is needed; and to a no less wasteful undersupply when restriction is called for. Moreover, mixing the issues leads to opposition to expansionary fiscal measures by those who oppose high provision for such goods and to opposition to restrictive measures by those who favour high provision of social goods. If the issues are separated, reasonable people may agree on the need for stabilizing action while differing, in line with their preferences, on the appropriate scale at which social goods are to be provided.

**Distribution and Stabilization:** Finally, consider the relationship between distribution and stabilization objectives. In the past it has been argued during periods of severe unemployment that lower-income groups should be given greater tax relief, since they are likely to spend more of their tax savings than higher-income recipients. The opposite case has been made in the period of inflation that taxes on low-income groups should be raised, since they are more potent in reducing demand than taxes on the higher incomes.

Also, a proper stabilization action may be interfered with or redistribution action may be biased

because the two objectives are linked. This is unnecessary since the stabilization adjustment can be made with distributional neutral tax (or any pattern of tax distribution) provided only that the overall level of taxation is raised or reduced by a sufficient amount.

**Distribution and Growth:** There is likelihood of similar problems to occur if the growth objective is presented. A higher rate of growth may demand for a higher rate of capital formation. This requires increased saving and investment. Since the marginal propensity to save is higher among high-income recipients than among low-income groups, and since high-income taxpayers undertake most investment, it would appear that the tax structure should be such as to concentrate on lower incomes. Again, the conclusion need not follow if we permit the possibility of public saving which for any given tax-burden distribution, may be achieved through higher tax rates. But, the conflict may not be resolved as easily if effects of taxation on investment incentives are considered. Unless larger reliance on public investment is introduced, a higher rate of growth may be in conflict with redistribution objectives.

It becomes evident from the discussion of these potential conflicts that the normative view of neatly an attuned sub-budget is not a realistic description of the fiscal process. Rather, it is a standard of measuring the actual performance and assessing the quality of existing fiscal institutions.

### **SELF ASSESSMENT EXERCISE**

Describe the likely conflict that may occur in an attempt to achieve allocation, distribution and stabilization objectives at the same time and show how this can be resolved.

### **3.3 INTERACTION OF PRIVATE AND PUBLIC SECTORS**

It is obvious from the preceding discussion that the functions of the public sector differ sharply from those pursued by private households or firms. But, both sectors interact and are linked in the overall economic process. This interdependence is illustrated in Figure 1-1, which presents a highly simplified picture of the circular flow of income and expenditure in the economy.

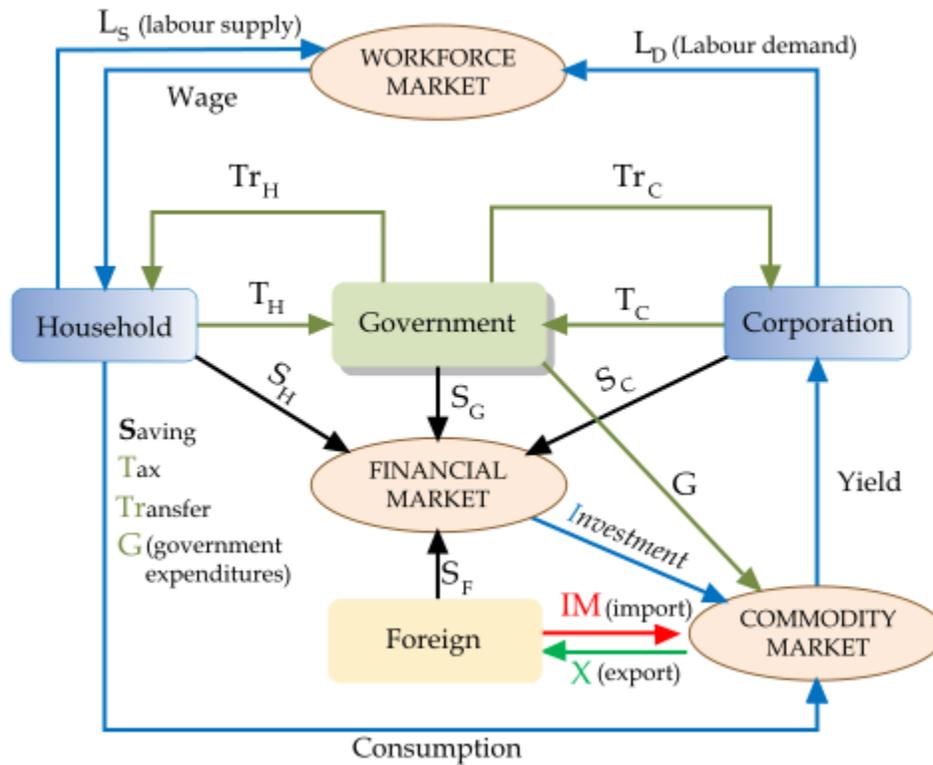
**Income and Expenditure Flows:** Figure 1-1 shows income and expenditure flows in the private sector and the public sector. Households obtain income through the sale of factors in the factor market (labour supply), this income is then spent or saved. Saving in turn finances investment expenditure. Combining in the purchase of products in the product market, give rise to the receipts of firms, which in turn are used for the purchase of factor services.

When the government is introduced, factors are bought by the public sector as well as by the private sector, and output of private firms is purchased by government as well as by private buyers. In addition to factor and product purchases, the government also makes transfer payments. Government revenue in turn is derived from taxes and from borrowing.

As this diagram shows, the private and public-sector flows are closely intertwined. Public sector participates as a buyer in the factor and the product markets. Its operations are thus an integral part of the pricing system. Hence, it is necessary, in designing fiscal policies, to allow for how the private sector will respond. Imposition of a tax at one point in the system may lead to responses which will shift the burden to a quite different point. Moreover, the government not only diverts private income to public use, but through factor and product purchases also contributes to the income flow to households. Therefore, public sector and private sector are both integral and interacting parts of a mixed economic system.

**Figure 1-2: Circulation in Macroeconomics**

*Circulation in Macroeconomics*



**Factor and Product Flows:** Figure 1-2 may also be interpreted as showing the real flows of factor inputs and product outputs instead of viewing it in terms of income and expenditure flows. Reversing the arrows and moving now in a counter clock direction, it show the flow of factor inputs into the private and public sectors and the flow of firm outputs to private and government buyers respectively. There is also the flow of public goods and services which are provided free of direct charge to the consumer. This flow, which bypasses the product market, is financed not through sales proceeds but through tax or through borrowing. Also, the goods and services which government provides are only in part produced by government (based on the factor inputs); the remainder is privately produced and sold to government.

**SELF ASSESSMENT EXERCISE**

Using a circular flow of income diagram, describe how public sector and private sector interact in both factor and product markets.

**4.0 Conclusion**

- From our discussion of the stabilization function, we have been able to identified that: Tax and expenditure policies affect aggregate demand and the level of economic activity. They are also an important instrument in maintaining economic stability including high employment and control of inflation.
- Although the functions of the public and private sector- differ in important respects. the operations of both interact in the product and factor markets as well as in the income and expenditure flows of the economy.
- Fiscal policies may be conducted in centralized or decentralized fashion with different budgetary functions being more or less appropriate at various levels of governmental activity.

## 5.0 Summary

This unit exposes us to government coordinate the achievement of allocation, distribution and stabilization objectives simultaneously and any conflict are resolved when it arise. The interaction of both government and private sector in macroeconomy was also considered. These are further expected to provide a good foundation in the course.

## 6.0 Tutor-Marked Assignment

In about two pages, explain how government resolves conflict in an attempt to achieve allocation, distribution and stabilization objectives simultaneously. How does this assist in the interaction of public and private sector in macroeconomic activities?

## 7.0 References/Further Reading

Buchanan, J.: "Social Choice. Democracy and Free Markets." *Journal of political Economy* December 1954.

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Houghton, R. W. (ed.): *Public Finance*, Baltimore: Penguin. 1970.

Musgrave, R. A.: *The Theory' of Public Finance*. New York: Mc Graw-Hill. J959, chaps. 1. 2.

Pigou, A. C.; *A Study in Public Finance*. London: Macmillan, 1928, pan 1.

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## Module Two Public Revenue

Unit 1	Public Revenue: General Consideration
Unit 2	Taxation
Unit 3	Tax Assignment and Tax Shifting
Unit 4	Taxation and Fiscal Policy

## Unit 1 Public Revenue: General Consideration

### CONTENTS

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3.0 Main Content
3.1 Sources of Government Revenue
3.2 Taxable Capacity
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## 1.0Introduction

Government provides good and services in the economy. Resources are required to provide these goods and services. A discussion of government revenue centered on the various sources of financing government activities or ways of withdrawing resources from the private sector for public use. This module provides a general consideration of government revenue. The first module introduces us to the four primary functions of fiscal policy vis allocation, stabilization, distribution and development. In carrying out these functions, the basic tools are taxation and expenditure policy of the government.

In recent time, public expenditure has increased substantially. The main reason is that the functions of governments have increased manifold. The modern states are no more police states but welfare states. Adolph Wagner, in his famous 'Law of Increase State Activities' states that 'comprehensive comparison of different countries and different times show that among progressive people with which alone we are concerned, an increase regularly takes place in the activity of both central and local governments.' This increase is both intensive and extensive. This module discusses in detail the meaning of public revenue, the sources of public revenue and related concepts.

## **2.0 Objectives**

At the end of this unit, students should be able to:

- (i) Understand the different sources of government revenue
- (ii) Understand taxable capacity
- (iii) Understand money creation as a means of government revenue

## **3.0 Main Content**

### **3.1 Sources of Government Revenue**

This is one of the branches of public finance. It deals with the various sources from which the state might derive its income. These sources include incomes from taxes, commercial revenues in the form of prices of goods and services supplied by public enterprises, administrative revenues in the form of fees, fines etc. and gifts and grants.

The income of government through is known as public revenue or public income. Public revenue can be defined in two ways vis: Narrow sense and broader sense. In the narrow sense, public revenue includes income from taxes, prices of goods and services supplied by public sector undertakings, revenue from administrative activities, such as fees, fines etc. In the wider sense public revenue includes all the incomes of the governments during a given period of time, including public borrowing from individuals and banks. Income from public enterprise is known as public receipts.

Public revenue includes that income which is not subject to repayment by the government. Public receipts include all the income of the government including public borrowing and issuance of new currency. In this way public revenue is a part of public receipts. Therefore,

$$\text{Public Receipts} = \text{Public revenue} + \text{Public borrowing} + \text{issue of new currency}$$

The sources of public revenue can be broadly classified in to two – tax -source and non- tax source. As earlier stated a discussion of the various sources of financing government activities revolve around different ways of withdrawing resources from the private sector of the economy for the purpose of government goods and services. The sources of financing government activities include:

- (i) **Taxation:** Taxation is used to withdraw resources from the private sector for public use. Taxes are compulsory payments imposed by legislation. However, since the burden of government goods and services must be borne by people who enjoy those goods and services, taxes may be view as charges

paid by the citizens to government to cover the cost of goods and services. In the case of the payment for public good via taxes, the point should be made that such payment may not be particularly divorced from the receipt of the benefits for such public goods and services. This is very much unlike the private sector where the receipt of a particular good or service is tied directly to the payment of a price as an integral part of the voluntary market exchange process. Thus, the amount of protection that an individual enjoys from police service for instance, does not depend on the amount that the individual pays in taxes. In the payment of taxes, two types can be identified viz direct and indirect taxes. Direct taxes are those imposed on income and are taxes whose burden cannot be shifted. Indirect taxes are those that are levied on goods and services. The burden of indirect taxes can be shifted.

- (ii) **Money Creation:** National government can also finance their plan by creating more money through the Central Bank. Government can instruct the Central Bank to print more money to carry out her activities. It is argued that money creation is politically painless because there is no sacrifice to create that money. The importance of money creation in the economy depends on whether the economy is operating on full-employment or there is substantial unemployment. If money is created at a time when substantial unemployment exists, then the money created will bring idle resources into employment. In other words, there will be no inflation under this situation. However, when economy is operating at full-employment money creation can be inflationary. It should be noted that when money is created, government is creating new purchasing power.
- (iii) **Borrowing:** This is another source of government financing. It involves the exchange of purchasing power i.e. getting money from the private sector to the public sector. There are internal and external borrowing. The importance of borrowing depends on whether the economy is at full employment or underemployment.
- (iv) **User Charges:** Government can charge for the goods and services she provided. This is referred to as user charges. User charges are only related to specific roles. This is different from taxation because taxation are levies imposed by legislation and payment of taxes are not tied to particular goods and services provided by the government. User charges are only feasible when the public good can be appropriated and the principle of exclusion holds in this situation.
- (v) **Commandeering of Resources:** Government can also finance the provision of goods and services by commandeering physical resources from the private sector of the economy. If for instance, the government want to build a road, she can confiscate labour materials from private firms and use them to build roads. In most rural communities, local roads building is usually carried out by commandeering physical resources. As the residence of the community compelled themselves to offer their labour for such services. Commandeering of physical resources to finance the provision of public goods and services is neither an efficient nor equitable way of distributing the burden or cost of public goods. For this reason, this method is likely to be resisted by the people affected. This is why the government tries to obtain command over purchasing power through taxation to finance public good.
- (vi) **Non - Tax Revenue:** The non-tax revenue includes commercial revenue i.e. income from public property and enterprises, administrative revenue (fee, fine, special assessment), gifts and grants and others. Commercial revenues are income earned by public enterprises by selling their goods and services. For example, payments for postage, tolls, interest on borrowed funds etc. Administrative revenue are receipts of incomes accrued on account of performing administrative functions by the government. The important items of administrative revenue are fees (court fee, license fee, passport fee etc.). Fines penalties are imposed on persons as a punishment for infringement of laws. Special

assessment is a compulsory contribution levied in proportion to the special benefit derived to defray the cost of specific improvement to property undertaken in the public interest. For example, when government constructs a highway, the prices of plots on either side of it will naturally go up. Therefore, the land owners may be required to bear part of expenses incurred by the government. Gifts and grants are the payments made by one government to another for some specific functions.

### **SELF ASSESSMENT EXERCISE**

Discuss the main sources of government revenue.

### **3.2 Taxable Capacity**

In recent time, public expenditure has been increased enormously. The main reason is that the functions of governments have increased manifold. The modern states are no more police states but welfare states. For meeting these financial obligations, huge amount of revenue is needed. Taxation is the major source of revenue. Taxation, however, reduces the purchasing power of the people and adversely affects their ability and willingness to work, save and invest. So, the capacity of the people to pay taxes should be taken in to account while increasing the tax rates or imposing new taxes. Taxable capacity has been defined differently by different writers and important definitions are described below:

Professor Dalton	Taxable capacity is a common phrase but a dim and confused concept
Joshiah Stamp	Taxable capacity is the minimum amount which the citizen can pay to the public authorities without having a really unhappy and downtrodden existence and without dislocating the economic organizations too much.
Findlay Shirras	Taxable capacity is the limit of squeezability. It is the total surplus of production over the minimum consumption required to produce that level of production, the standard of living remaining unchanged.
Indian Taxation Enquiry Commission-1954	Taxable capacity of the different sections of the community may be said to refer to the degree of taxation, broadly speaking, beyond which productive efforts and efficiency as a whole begin to suffer.

#### **3.2.1 Determinant of Taxable Capacity**

The determinants of taxable capacity are:

- (i) National income and wealth
- (ii) Size of population
- (iii) Standard of living of the people
- (iv) Nature of public expenditure
- (v) Psychological attitude of the people
- (vi) Stage of economic growth
- (vii) Political conditions
- (viii) Tax structure
- (ix) Fiscal, monetary and income policies of the governments
- (x) Favourable balance of trade
- (xi) Inflow of foreign capital
- (xii) Technological progress
- (xiii) Modernization of production pattern etc.

### **SELF ASSESSMENT EXERCISE**

Discuss the main determinants of taxable capacity.

## 4.0 Conclusion

From our discussion on the general consideration of public revenue we have been able to identify:

- the main source of government revenue.
- Definition of Taxable capacity
- Determinants of taxable capacity

## 5.0 Summary

This unit described the main sources of government revenue and the determinants of taxable capacity. It provides a detail discussion of the sources of government revenue and definition of taxable capacity. This provide foundation for an explicit discussion of taxation in the next unit.

## 6.0 Tutor-Marked Assignment

Submit a two-page essay sources of government revenue and taxable capacity.

## 7.0 References/Further Reading

Kaplow, L. (2008), *The Theory of Taxation and Public Economics*, Princeton University Press.

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## UNIT 2 Taxation

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3.3 Merits and Demerits of Direct and Indirect Tax

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### 1.0 Introduction

Musgrave (1969), advocated public expenditure since government is forced to do many activities such as reallocation of resources, redistribution activities, stabilizing activities and commercial activities. The governments need income for the performance of their variety of functions and meeting their expenditure.

Taxation can be used as anti-inflationary and anti –deflationary measure. Taxation is important as a means of reducing the purchasing power in the hands of the people and cutting their spending. This unit discusses various forms of taxes and their impacts on the economy. It also discusses taxation as a fiscal policy tool of government and other issues related to taxation.

## **2.0 OBJECTIVES**

At the end of this unit, students should be able to:

- (vi) Understand the main source of government revenue
- (vii) Understand different types of tax and
- (viii) Understand the difference between public revenue and public receipts
- (ix) Be able to distinguish between direct and indirect tax

## **3.0 MAIN CONTENT**

### **3.1 Direct Tax**

Tax is a compulsory contribution from a person to the government to defray the expenses incurred in the common interests of all without reference to special benefits conferred. It is a compulsory payment to the governments without expectation of direct return to or benefit to the tax payer. The essence of a tax, as distinguished from other charges by government, is the absence of a direct quid pro quo between the tax payer and the public authority. Taxation helps to stabilize economy and it can be used as automatic stabilizer in the economy. It can also be used for redistributive justice. Two types of tax can be identified in any economy vis: direct and indirect taxes.

Direct taxes are imposed on income whose burden cannot be shifted. Direct taxes are imposed on income or wealth of a person. Direct taxes are those which are paid by persons on whom these are imposed and the real burden is also borne by them. The burden of such taxes cannot be transferred or shifted to some other persons. That is, in the case of direct taxes both impact and incidence fall upon the same person. Example of direct tax include poll tax, personal income tax, corporate tax, direct assessment tax. Examples of direct tax include personal income tax, pool tax, corporate tax, direct assessment tax. Poll tax is imposed on individual by the colonial master in Nigeria and it was independent of income. It was a flat rate in the past and highly regressive. The direct assessment tax lies between poll tax and personal income tax. It is a form of poll tax but is graduated. By this, it means that people who earn income pain different amount of tax. Assessment of the tax is based on estimate and may be subject to wide margin or error, hence, not consistent with the principle of equity.

Personal income tax has the potential of increasing revenue conforms with the accepted standard of equity. It can also be used to re-distribute income. As economic growth progress, there is a graduate shift from reliance on indirect taxes to direct taxes as a form of revenue. Thus, the important of personal income tax increases with economic growth. Personal income tax is graduated implying that people with different income are tax differently. However, personal income tax is bedeviled with the following problems:

- (i) Problem of definition of income: income consists of all economic gains that an individual earned or gained during the tax period. However, there is a problem of non-monetary transaction e.g. free medical care, free transport, free-housing.
- (ii) It does not take care of those good that do not enter into the exchange economy.

- (iii) Problem of capital gain: The question is should they be regarded as income. If so, when should they be taxed. Tax structure has been developed to resolve this problem that the tax should be imposed at the time the property is seen proposed.

### **SELF ASSESSMENT EXERCISE**

Discuss the purpose of tax in an economy and mention and discuss different types of direct tax.

### **3.2 Indirect Tax**

Indirect taxes are imposed on one person but paid either partly or wholly by another. The person who pays the tax in the first instance, transfers its burden to another person. In other words, the impact and incidence of indirect tax fall on different persons. Examples of indirect taxes are sales tax, excise duty, value added tax (VAT) etc. Custom duties (export duties and import duties) are imposed on imported goods. It is a very good source of income for the government. Excise duties are imposed on domestically produced goods. They are highly discriminating because it can be imposed on certain good and not on other goods. Excise duties are not important source of government revenue in developing countries because the manufacturing sector are still minute. Another type of indirect tax is sumptuary tax. Sumptuary tax is not for raising revenue but to discourage people from consuming particular goods. Sale tax is another type of indirect tax. Two types can be identified vis: single stage-tax and multi stage-tax. Single-stage tax takes place between the producer and the consumer while multi-stage tax is imposed anytime the good changes from one individual to another. VAT is a tax imposed at every stage of production. It is usually imposed on the net-value added. To this extent, VAT can be regarded as an example of multi-stage tax.

Export duties are imposed on good exported out of the country. They serve as a substitute for personal income tax for the farmers. It is argued that this form of taxation is very easy to collect. It has also been argued that it is not equitable because it applied to those farmers who produced for export. People have also argued against export tax because it subjected the farmers to double taxation. It is a major source of revenue up to 1960's in Nigeria but it has decreased remarkably from the period of oil boom.

### **SELF ASSESSMENT EXERCISE**

Discuss the main differences between direct and indirect tax. What are the major examples of indirect tax.

### **3.3 Merits and Demerits of Direct and Indirect Tax**

The distinction between direct and indirect taxes is more commonly drawn by reference to the basis of assessment rather than the point of assessment. Direct taxes strike a citizen's income at the moment of its production. The direct and indirect taxes are like two attractive sisters between whom an exchequer should be perfectly impartial. According to P.E. Taylor, the terms direct and indirect taxes are distinguishable in meaning only in terms of suitability. Direct taxes are not shifted while indirect taxes are. From the above we can conclude that direct taxes are those which are paid by persons on whom these are imposed and the real burden is also borne by them. The burden of such taxes cannot be transferred or shifted to some other persons. That is, in the case of direct taxes both impact and incidence fall upon the same person. Indirect taxes are imposed on one person but are paid either partly or wholly by another. The person who pays the tax in the first instance, transfers its burden on the shoulders of another person i.e. the impact and incidence of indirect tax fall on different persons. Following these, the merits and demerits of direct and indirect taxes are discussed below:

The merits of direct taxes are:

- (i) Equity: direct taxes such as income taxes, taxes on property, capital gain taxes etc. are progressive in their nature. That is, higher incomes are taxed heavily and lower incomes are taxed lightly. Hence, direct taxes are based on ability to pay of the tax payer and they ensure the canon of equity.
- (ii) Economy: The administrative cost of collecting the direct taxes is low. The tax payers directly pay the tax to the state. So, there is not much waste of resources and time. That is, direct taxes satisfy the canon of economy.
- (iii) Certainty: Another merit of direct tax is that it is certain. The tax payers know how much tax is to be paid, on what basis tax is paid to the government etc. Thus, the tax payer is able to make adequate provision the payment of tax in advance. The government can also plan development activities since they can estimate the amount of revenue they receive in the form of taxes.
- (iv) Elasticity and revenue generation: the yield from direct taxes increases as the country economically advances. The government gets more revenue through direct taxes automatically at higher rates.
- (v) Distributive justice: Since direct taxes are progressive in rates, tax rate increases as the income of individuals rises. The tax burden will heavily be on the richer sections of the society. The increased revenue through taxes is allocated for providing subsidized food, clothing and housing to the poor and needy people. This will bring about distributive justice in the country.
- (vi) Civic consciousness: Direct taxes create civic consciousness among the tax payers. The tax payers will be vigilant in the utilization of the tax revenue and will see whether the resources are efficiently used and wastage is avoided.
- (vii) Absence of leakages: since there is direct payment of taxes by tax payers to the government, there is no room for any wastage. The whole amount of direct taxes such as income taxes, property taxes, and taxes on capital gains etc., reaches the treasury without any middlemen.

The demerits of direct taxes on the other hand include:

- (i) Uncertainty: The precise degree on needed progression cannot be estimated on account of the difficulties of measuring the ability to pay and the subjective nature of the marginal utility of income.
- (ii) Unpopularity: the direct taxes are directly imposed on individuals. They have to bear both the impact and incidence of these taxes. Thus, they experience their pinch directly. Consequently, direct taxes are not as popular as indirect taxes.
- (iii) Violation of the principle of equity: the burden of direct taxes falls almost exclusively on the richer sections of the society while the poorer section is totally exempted from these taxes. This is unjustified and improper because the burden of state expenditure should be borne by individuals at all levels of society according to their ability to pay.
- (iv) Large scale evasion: direct tax is based on honesty. The tax is not evaded only when the tax payer is honest. It is a fact that the people in the higher income groups do not reveal their full income. It is remarked that “direct taxes are a premium on honesty.”

The merits of indirect taxes are:

- (i) Convenience: Indirect taxes are more convenient to pay. It is paid at the time of purchase of a commodity. Hence, the tax payer does not feel the burden of tax. The tax is hidden in the price of the commodity bought. It is paid in small amount. The government can also collect it conveniently.
- (ii) Indirect taxes lead to social welfare: indirect taxes on narcotics and intoxicants reduce the consumption of them which are harmful to health. Reduction in the consumption of such goods will indirectly increase the welfare of the people.

- (iii) Indirect taxes are justified: indirect taxes are justifiable and equitable. They are paid by all the individuals and when they purchase goods and services.
- (iv) Indirect taxes help production and investment: Another advantage of indirect taxes is that they perform as powerful tool in molding the production and investment activities of the economy.
- (v) No evasion: Indirect taxes are generally difficult to be evaded as they are included in the price of the commodity. A person can evade an indirect tax only when he decides not to purchase the taxed commodity.
- (vi) Highly revenue yielding in developing countries: direct taxes do not yield much income in developing countries, as the income of the people is very less. Since indirect taxes cover a large number of essential commodities to be consumed by both the rich and the poor in the country, large revenue could be collected.

The demerits of indirect taxes are:

- (i) Indirect taxes promote inequality: Indirect taxes are generally imposed on the consumption goods. The poor people have to pay as much by way of indirect taxes on commodities as the rich people. This is unjust and equitable. They are regressive in nature which will promote economic inequality in society by imposing larger burden of taxes on the poor people.
- (ii) Uneconomical: Indirect taxes involve high costs of collecting them. To raise desired levels of public revenue, taxes should be collected from millions of people.
- (iii) Element of uncertainty: Indirect taxes are extremely uncertain. The revenue accrued to the government from indirect taxes cannot be estimated accurately. As soon as the tax is imposed, the price of the commodity is raised. This will in turn reduce the demand for the commodity. It cannot be estimated with certainty as to what extent the demand falls.
- (iv) Lack of civic consciousness: Indirect taxes do not create civic consciousness as the tax payers in most cases do not feel the burden of the tax they pay.
- (v) Indirect taxes promote inflation: another demerit of indirect taxes is that it promotes inflationary tendency in the economy, as they would increase the prices of the taxed goods.
- (vi) Discourage saving: Indirect taxes discourage savings because they are included in the prices of commodities. Therefore, people have to spend more on the purchase of commodities. This will reduce the disposable income of the people and hence the savings.

### **SELF ASSESSMENT EXERCISE**

Discuss the main merits and demerits of direct and indirect taxes

## **4.0 Conclusion**

From our discussion so far on taxation, we have been able to identified that:

- taxes are the main source of government revenue.
- taxes comprise of direct and indirect taxes
- both direct taxes and indirect taxes have their advantages and limitations.
- taxation helps to stabilize economy and can be used as automatic stabilizer in the economy.
- taxation can also be used for redistributive justice.

## **5.0 Summary**

This unit has introduced us to the meaning and importance of taxation in any economy. It further exposes the different types of tax and their merits and shortcomings. It outlines the advantages and disadvantages of direct and indirect taxes. All these are expected to have provided a good foundation for the understanding of the subject matter of this module.

## **6.0 Tutor-Marked Assignment**

Submit a two-page essay on the importance of taxation to government in Nigeria.

## **7.0 References/Further Reading**

Kaplow, L. (2008), *The Theory of Taxation and Public Economics*, Princeton University Press.

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## **Unit 3                      Tax Assignment and Tax Shifting**

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    3.3 Impact, Incidence and Shifting of Taxation

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6.0 Tutor-Marked Assignment

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### **1.0 Introduction**

This unit continues the discussion on taxation by looking at the allocation of tax (technically refers to as tax assignment), the burden of tax (technically refers to as the burden of tax) and how easy it is to shift the burden of the tax from individual to another. Tax assignment involves efficiency of tax collection (i.e. economies of scale), fiscal independence and fluidities of the tax base. These three factors determine the volume of tax collection and the amount of tax revenue available to government.

This unit discusses in detail the tax shifting, tax incidence and its impact. It also discusses the principles of taxation and the implications of these principles on tax assignment, tax shifting and the incidence of taxation.

## 2.0 Objectives

At the end of this unit, students should be able to:

- (i) Understand the principles of taxation
- (i) Understand tax assignment, tax shifting and incidence of tax
- (ii) Understand the impacts of the incidence of tax in the economy

## 3.0 Main Content

### 3.1 Principles of Taxation

The criteria used for constructing a good tax structure are called principles of taxation. The principles of taxation relate to the distribution of taxation or allocation of tax burden to different categories of tax payers. Some of the important principles taxation are explained below.

- a) **Principle of Equity:** This principle implies fairness in the distribution of burden of taxation. In other words, equity in taxation means all tax payers should bear an equal sacrifice in the payment of taxes. There are two types of equity vis horizontal equity and vertical equity.

Horizontal equity implies the treatment of like people in a like manner. That is, persons who are equally well-off should be treated equally. To secure horizontal equity, persons with same income should pay equal amount of taxes.

Vertical equity implies that unlike people should be treated in an unlike manner. That is, the persons who are well-off should pay higher taxes than the worse-off people. This principle is very difficult to practice, though looks to be attractive. To establish both horizontal equity and vertical equity there are some other principles of taxation that must be observed. These are the benefit principle, the ability to pay principle and the cost of service principle.

- b) **The Benefit or Quid Pro Quo Principle**

This principle explains that tax should be paid in accordance with benefits each receive from expenditure programmes to be financed by tax revenues by the governments. According to this principle people receiving equal benefits should pay equal amounts of taxes and those who receive greater benefits should pay higher taxes. There are some advantages of this principle and they include:

- Justification for taxes- That is taxes are imposed only when benefits are conferred on tax payers out of the tax revenue.
- It satisfied Equity principle- It is equitable that individuals receiving benefits from the state expenditure should contribute in proportion with the benefits enjoyed by them.
- No discouragement to work and invest - As taxes are imposed on the basis of benefits, they do not discourage the willingness to work and invest.
- Basis for allocation of taxes- Taxes are allocated to the extent of benefits received.
- It combines both the income and expenditure sides of the budget process.

However, the disadvantages of this principle are:

- It is an injustice to poor: Since modern governments are aiming at welfare states, more benefits will be provided for the poorer people. When taxes are imposed on the basis of benefits, tax burden will heavily be upon the poor. This principle is regressive in nature.
- Non –applicability of market principle: The market principle of demand and supply is not applicable to social goods like education, defense, public health etc. They are supplied equally by governments for collective consumption. It will be difficult to estimate the benefits since nobody will reveal their preferences.
- Satisfaction of merit wants: The benefit principle of taxation is not applicable to merit wants since they result in interference in consumers’ sovereignty.
- Benefits are community based or group based: Benefits from social goods are enjoyed by community than by individuals, hence, beneficiaries cannot be individually identified.
- Certain benefits are immeasurable: Some benefits of public expenditure cannot be quantified. For example, benefits from public parks, recreation, museums, research centres etc.
- Violation of tax definition: The very definition of tax is violated as per the benefit principle. Tax is defined as a compulsory contribution without direct benefits.

### **c) Ability to Pay Principle**

This principle states that those people who possess income or wealth should contribute to the state in proportion to their ability to pay. The basic point of the ability to pay principle is that the burden of taxation should be shared amongst the members of the society so as to conform to the principle of justice and equity which will be satisfied if the tax burden is determined according to the relative ability of the tax payers. The burden of taxation should be so distributed that the direct real burden on all tax payers is equal. The ability to pay principle explains the fairness or justice in the distribution of tax burden. The implications of this principle mean that:

- Tax is a compulsory contribution.
- Public expenditure and public revenue are two distinct entities. Public expenditure is provided for the common goods and the public revenue is raised through taxation from the individuals according to their ability.
- Taxes should be imposed by the state in an equitable or just manner.
- Taxes should be imposed to minimize the total sacrifice involved.
- It emphasizes welfare aspect not only of tax shares but also of expenditure.

However, ability to pay principle has the following limitations:

- Income is the main determinant of ability.
- The theory is based on some unrealistic assumptions like utility is quantifiable and interpersonal comparison of utility is possible.
- Marginal utility of income is known and declines as income increases.
- The principle is a vague theory that does not have a comprehensive definition. It has three interpretations of equal sacrifice and one does not know which of the three-equity rule to adopt.

### **3.1.1 Indices of Ability to Pay**

To measure ability to pay, two important approaches are used by economists’ viz: the subjective (equal sacrifice) approach and the objective (faculty) approach.

#### **(i) The Subjective Approach**

This approach is based on the psychological or mental reactions of the tax payers. Each tax payer should make equal sacrifice, if tax burden is equally distributed. There are three concepts of equal sacrifice principle. These are equal absolute sacrifice, equal proportionate sacrifice and equal marginal sacrifice. The equal absolute sacrifice states that loss of utility should be equal to all tax payers. It means that rich people should pay higher taxes than the poor. The equal proportionate sacrifice implies that the loss of utility should be proportional to the total income of the tax payers. That is, higher income people should be taxed at a higher level than that of the poor. For each individual the ratio of utility lost to total utility should be equal.

$$\text{Rate of tax} = \text{Sacrifice of A/Income of A} = \text{sacrifice of B/Income of B}$$

On the other hand, the equal marginal sacrifice, also known as least aggregate sacrifice says that total sacrifice made by all the tax payers should be the lowest.

### **(ii) The Objective Approach**

This approach explains three criteria to measure ability to pay viz: income, property and consumption. Income is considered to be the best index of ability to pay. Income include income from all sources such as property, investment in shares etc. in a given period. Formerly property or wealth was considered as the index of ability to pay. This was due to the fact that the standard of living of the people was not only influenced by income but also by the accumulated property and wealth. However, this criterion suffers from many limitations and conceptual difficulties. For example, properties of the same size and description may not yield the same income. Many economists have suggested consumption expenditure as the basis of ability to pay. The major difficulty of this measure is that person with large dependents have to spend more and hence to pay larger taxes. This is against the equity principle of taxation.

### **(iii) The Cost of Service Approach**

According to this approach each tax payer should pay tax equal to the cost rendered by the government to provide a service. For example, if an individual received 0.3% of total services, he has to pay 0.3% of total cost involved in providing such services. If the cost is higher, the tax will also be higher. Taxes are like prices paid for services rendered to each person by the governments according to the cost incurred. The limitations of this approach are

- It is difficult to estimate the cost of all services. For example, defense.
- It is against the welfare object of the governments. If cost is taken as the basis of tax, the governments may not perform many functions which are desirable for the welfare of the society.
- It is against the very definition of tax. Tax is a compulsory contribution and there is no direct quid-pro-quo.
- The cost of services rendered by governments to individuals is fixed arbitrarily which is not just.

## **SELF ASSESSMENT EXERCISE**

Discuss the main principles of taxation.

### **3.2 Tax Assignment and Tax Shifting**

Tax assignment refers to who should collect tax. Three factors are prominent in allocation of tax viz: efficiency of tax collection (economies of scale), fiscal independence and fluidities of the tax base. Taxes like custom duties, company corporate tax etc. are assign to the federal government while value - added tax ate assigned to the state government. Market tolls are assigned to the local government. Factors important in assigning taxes are:

- (i) Fiscal Independence: - This require that taxes should be assigned to each layer of government from which they can generate adequate revenue to carry out their constitutionally assigned duties. However, this point is not strictly adhered to in many countries, especially Nigeria.
- (ii) Fluidities of Tax base: - What to be tax is the tax base. The more mobile the tax base is, the easier it is to collect tax. if it is highly mobile, it is desirable of assign it to the federal government. This method is likely to be resisted by the people affected and this is why government tries to obtain command over purchasing power through taxation and other means of creating money to finance public goods e.g. borrowing and in some cases money creation.

### **SELF ASSESSMENT EXERCISE**

What are the main determinants of tax assignment.

## **3.3 Impact, Incidence and Shifting of Taxation**

There is large number of taxes in modern time and to understand the various social and economic effects of taxes it is important to examine terms like impact, incidence and shifting. The amount of tax imposed by government is paid by someone. In some cases, the tax burden is not borne by the person on whom the tax is imposed. We need to know to know who pays the tax initially and who actually bears the tax burden in order to understand this better. In short, a tax may be imposed on one person; the burden of the same tax may be transferred to a second person or transferred to others who ultimately bear the burden. This is explained in the theory of incidence. In order to understand the theory of incidence, it is essential to distinguish between impact, shifting and incidence.

### **3.3.1 IMPACT**

Impact is the initial phenomenon, shifting is the intermediate process and incidence is the result. Impact is otherwise called statutory tax incidence. It implies the burden of a tax borne by the person on whom it is imposed. In other words, impact refers to the immediate burden of a tax or the person who first bears the legal obligation of a tax.

### **3.3.2 SHIFTING**

The process of transferring the burden of a tax from one person to another is called shifting. The producer may shift the tax burden to the wholesaler, the wholesaler to the retailers, and the retailers to the consumers etc. This is done through the changes in prices. This is a case of forward shifting. Forward shifting may be multi-point or single-point. The case explained above is an example of multi-point shifting. When the tax burden is shifted by a producer to consumers directly it is a case of single-point shifting. Shifting may also be backward. Backward shifting refers to shifting of tax burden to sellers by buyers. An example of backward shifting is tax capitalization.

### **3.3.3 INCIDENCE**

The final burden of a tax is called incidence. It is the money burden of a tax which is borne by the last person. That is, the incidence of a tax is the final resting place of it. It implies who finally paid the tax.

### **3.3.4 DISTINCTION BETWEEN IMPACT AND INCIDENCE**

There are four major distinction between impact and incidence of tax as follows:

- (i) Impact refers to the initial burden of the tax, while the incidence is the ultimate burden of the tax.
- (ii) Impact is at the point of imposition, while incidence is at the point of settlement.
- (iii) The impact of a tax falls upon the person from whom the tax is collected and the incidence rests on the person who eventually pay it.
- (iv) The impact may be shifted but the incidence cannot be shifted.

### **3.3.5 EFFECTS AND INCIDENCE OF TAXATION**

In economic analysis, incidence and effects are used to denote different connotations. As stated earlier, incidence is the final money burden of a tax whereas effects of tax refer to the economic consequences of a tax on production, consumption, distribution, and exchange. The study of effects is broader than the study of incidence as taxes affect production, consumption, savings, investments, growth, regional balance, distribution of income and wealth and so on.

### **3.3.6 CONCEPTS OF TAX INCIDENCE**

There are different concepts of tax incidence. The three important views on the concept of tax incidence are the following.

- (i) Dalton's Traditional Concept
- (ii) Hick's Concepts of Formal and Effective Incidence and
- (iii) Musgrave's Concept of Incidence.

#### **3.3.6.1 Dalton's Concept of Incidence**

Dalton distinguished between the direct and indirect burden as well as the money burden and real burden of the tax. According to him, "the incidence of a tax is upon those who bear the direct money burden of the tax." The total direct money burden of a tax is the total tax revenue. The total direct real burden of tax refers to the loss of economic welfare due to payment of tax. The indirect real burden is the reduction of consumption or a fall in savings. The direct real burden and indirect real burden together constitute the effects of taxation. Hence, the incidence of taxation is the direct money burden of a tax. That is, the actual initial payments of tax which may either fall upon a person on whom it is initially imposed or if shifting is possible, upon some other persons by whom the tax money is finally paid.

#### **3.3.6.2 Hicks' Concept of Incidence**

Ursula Hicks classified incidence of taxation into — formal incidence and effective incidence. Formal incidence means the direct money burden of a tax. The formal incidence is "the proportion of people's income collected by the persons who provide them with goods and services, but paid over to governing bodies to finance collective satisfactions." Effective incidence refers to the difference between economic order relating to income distribution, consumption pattern, and allocation of resources before taxation and after taxation." In order to discover the full economic consequences of a tax, we have to draw and compare two pictures- one of the economic set up (distribution of consumers' wants and incomes, and allocation of factors) as it is with the tax in question; the other of a similar economic set up, but without the tax. It is convenient to call the differences between these two pictures the effective incidence of the tax." In short, the effective incidence is nothing but the economic effects of the tax.

#### **3.3.6.3 Musgrave's Concept of Incidence**

According to Musgrave "a change in the distribution of income available for private use which arises as a result of changes in budget policy is called incidence." That is, the distributional change caused by changes in budgetary policies that involve resource transfer is incidence. The budgetary policy may either be tax policy or expenditure policy bringing about distributional changes. According to him there are

five forms of incidence viz: specific tax incidence, differential tax incidence, specific expenditure incidence, differential expenditure incidence and balanced budget incidence.

##### **(i) Specific Tax Incidence**

The distributional change in income brought about by a change in tax policy, when there is no change in expenditure policy is called specific tax incidence.

##### **(ii) Differential Tax Incidence:**

Expenditure policy is kept unchanged under this. One tax is substituted for another, money income (yield) is the same, the resulting distributional change is called differential tax incidence. The difference in the distributional results of two tax policies that provided for equal yield in real terms” is called differential tax incidence.

**(iii) Specific Expenditure Incidence**

The distributional effects as a result of a change in public expenditure, the tax policy remaining the same, are called specific expenditure incidence. The specific expenditure incidence is associated with the effects of inflation and deflation.

**(iv) Differential Expenditure Incidence**

Differential expenditure incidence refers to the resultant change in the distribution of income when public expenditure policy is changed under conditions of balanced budget so as to avoid inflation and deflation. When the budget is balanced, an increase in public expenditure in one direction is compensated by a decrease in public expenditure in another direction.

**(v) Balanced Budget Incidence:**

The resulting change in distribution when tax-expenditure policy is changed under conditions of balanced budget is referred to as balanced budget Incidence. For example, if the government wants to increase its expenditure, its tax function should be changed to obtain additional revenue. This will bring about changes in distribution.

### **3.3.7 Theories of Tax Shifting and Incidence**

There are different theories to explain the shifting and incidence of taxation. They are classified into three categories viz: the concentration theory, the diffusion theory and the modern theory.

#### **3.7.1 The Concentration Theory**

The concentration theory was developed by the Physiocrats in the 18th century. The Physiocrats believed that all taxes concentrate on a particular kind of people and regarded agriculture as the only productive activity that yielded surplus. They advocated a single tax on the net income of land. According to them diversity of taxes should be avoided. The major criticism against the theory is that all activities are productive and a single tax on land is not suitable for modern welfare states. Similarly, the burden should not be concentrated on a single section of the society but instead there should be equal distribution of tax burden on the entire society. However, the theory stresses that all taxes should be paid out of surplus and if there is no surplus the burden of the tax is shifted to others.

#### **3.7.2 The Diffusion Theory:**

This theory explains that a tax is shifted and re-shifted till its burden eventually gets distributed throughout the entire society in such a way that each individual tax payer bears only a small portion of the tax which he/she ought to bear and is capable of bearing. This theory was propounded by some French writers like Mansfield and Canard. According to Mansfield, “Tax is like a stone falling into a lake and making a circle till one circle produces and gives motion to another and the whole circumference is agitated from the centre.” When a tax is imposed it gets diffused so that no one escapes from its burden. The diffusion occurs through the process of shifting. Equilibrium is reached when the tax burden is equally distributed among all the tax payers. Canard, on the other hand, compared the imposition of tax to extracting blood from one of the veins of a human being; although it is taken from a single vein, the loss is spread over the whole body and the body remains in equilibrium. Canard believed that old taxes are preferable to new taxes, as new taxes would upset equilibrium till it got diffused. He concluded that, “Every tax is good, every new tax is bad.”

#### **3.7.3 The Modern Theory of Incidence (Demand & Supply Theory)**

The modern theory of tax incidence was developed by Dalton and was supported by modern economists like Seligman and Edgeworth. The theory states that tax should be imposed on surplus because tax is

part of cost of production and therefore, enters into price. Shifting of tax burden is thus done through price changes and shifting of tax burden is impossible without price transaction. Thus, shifting is common in commodity taxation. Therefore, shifting and incidence depend on pricing. Pricing in turn depends on the interaction of the market forces of demand and supply. The factors influencing the demand and supply are therefore have paramount importance in understanding the nature of tax shifting as well as determination of the incidence of a tax. The most important factors which affect demand and supply are the elasticity of demand, the elasticity of supply, the laws of returns, and market structure - perfect competition, monopoly, monopolistic competition, and oligopoly.

### 3.7.3.1 Elasticity of Demand and Supply

According to Prof. Dalton, “incidence of a tax is divided between buyers and sellers in the ratio of the elasticity of supply to elasticity of demand.” That is,  $E_s/E_d$  where  $E_s$  = elasticity of supply and  $E_d$  = elasticity of demand. The important propositions of the modern theory of incidence may be summarized as follows:

- (i) When  $E_d = \infty$  or  $E_s = 0$ , the whole incidence is on the sellers.
- (ii) When  $E_s = \infty$  or  $E_d = 0$ , the whole incidence is on the buyers.
- (iii) When  $E_d = E_s$ , the burden is equally divided between the buyers and sellers.
- (iv) When  $E_s > E_d$ , more incidence is on the buyers
- (v) When  $E_d > E_s$ , more incidence is on the sellers

Table 2.1 below show types of elasticity, the burden on the buyers and the burden on the sellers

**Table 2.1**

<b>Types of Elasticity</b>	<b>Burden on Buyers</b>	<b>Burden on Sellers</b>
Perfectly elastic demand	Zero	Entire
Perfectly inelastic supply	Zero	Entire
Perfectly inelastic demand	Entire	Zero
Perfectly elastic supply	Entire	Zero
Elasticity of demand = Elasticity of Supply	Equal	Equal
$E_s > E_d$	Higher	Lower
$E_d > E_s$	Lower	Higher

### 3.8 Laws of Returns and Tax Shifting

Different cost conditions will divide tax incidence between buyers and sellers differently. In an increasing cost condition i.e. with diminishing returns to scale which occur when per unit cost rises as more output is produced. In other words, when supply can only be increased at a higher per unit cost. Here, the incidence is partly on the seller and partly on the buyer. And if demand is less elastic, incidence will be more on the buyer. Similarly, when demand is more elastic, larger incidence is on the seller.

In a constant cost returns to scale situation in which per unit cost remains the same even if the supply is reduced, the seller will shift the entire incidence to the buyers while under a decreasing cost i.e. increasing returns to scale, the per unit cost falls as more output is produced and price will increase more than the amount of the tax.

### 3.9 Incidence of Tax under various Market Conditions

#### (a) Perfect Competition

Shifting of tax incidence under perfect competition depends on the time element, whether it is market period, short period or long period. During very short period or market period, shifting of the tax

depends upon the durability of the good. If the good is perishable, the seller will bear the incidence because if price increases, his stock will remain unsold and damaged. But if the good is durable, tax is shifted. The extent of shifting will be determined by the elasticity of demand. The tax is shifted partly to the buyer and partly to the seller in the short period. If the demand is relatively elastic, the larger incidence will be on the seller; if it is relatively inelastic the larger incidence will be on the buyer. In the long run, all costs are included in the price. A tax on a good is treated as cost of production and recovered from the buyer. Thus, in the long period, the tax is treated as cost of production and the whole tax is shifted to the buyers.

### **(b) Monopoly Market and Tax Shifting**

Monopoly is a market situation where a single seller controls the entire supply of a commodity which has no close substitutes. The seller is a price maker and maximises profit where  $MC=MR$ . A tax increases the cost of production. Monopoly taxes are of two types - lumpsum tax and advalorem or specific tax. In the former case, the monopolist would bear the whole incidence and in the latter case, the monopolist will shift the tax burden partly to the buyer depending on the elasticity of demand for the good.

### **(c) Monopolistic Competition and Tax Shifting**

In monopolistic competition, there are many competing firms but with product differentiation. Each firm has its own demand curve, elasticity of which depends upon the extent of product differentiation. If the product is highly differentiated, the demand curve is less elastic; the firm can easily shift a large part of the tax to the buyers through an increased price. If product differentiation is not much, the demand curve will be highly elastic and therefore the larger incidence will be on the sellers.

## **3.10 Factors Influencing the Process of Shifting of a Tax**

As earlier stated, elasticity of demand and the elasticity of supply are the two important factors determining the shifting of tax burden. Besides these two factors, the following factors also influence the shifting of a tax:

- (i) Form of quoting the price
- (ii) Rate of tax and Type of the market
- (iii) Availability of substitutes
- (iv) Geographical coverage
- (v) Time allowed for tax shifting
- (vi) General economic conditions
- (vii) Familiarity of consumers with a particular set of prices
- (viii) Public policy etc.

## **4.0 Conclusion**

From our discussion in this unit we have been able to identified that:

- Different principles of tax
- Determinants of impact, incidence and shifting of tax
- The role of demand and supply in determination of the incidence and shifting of tax
- The role of cost in determining tax shifting
- Factors the influenced the process of tax shifting

## **5.0 Summary**

This unit provided a detail discussion of the principles of tax, impact, incidence and shifting of tax. It exposes different theory and determinants of tax incidence and shifting. It also, explains how incidence of tax are shared under demand and supply. All these are expected to further provide a good understanding of the subject matter of this module.

### **6.0 Tutor-Marked Assignment**

Using the tools of demand and supply, gives a detail explanation of how tax incidence and tax shifting are determined in a market economy.

### **7.0 References/Further Reading**

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## **Unit 4 Taxation and Fiscal Policy**

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## **1.0 Introduction**

The role of fiscal policy relates to the stabilization of the rate of growth of any country. Fiscal policy through variations in government expenditure and taxation affects national income, employment, output and prices. This section looks at the meaning and objectives of fiscal policy and the role of taxation in fiscal policy. This provides linkage among previous discussions in units 1-3 of this module. It provides explanations on how government carries out her growth and stabilization policy in the economy. The discussion here includes meaning and objectives of fiscal policy, taxation and fiscal policy, the budgetary policy and the effects of taxation in the economy.

## **2.0 Objectives**

At the end of this unit, students should:

- (i) Understand the meaning of fiscal policy
- (ii) Understand taxation as a tool of fiscal policy
- (iii) Understand the effects of tax on the economy and individuals
- (iv) Understand the role of taxation in economic growth and stabilization

## **3.0 Main Content**

### **3.1 Meaning and Objectives of Fiscal policy**

Fiscal policy means the use of taxation and public expenditure by the government for stabilization or growth. It refers to government actions affecting its receipts and expenditures which ordinarily taken as measured by the government's receipts, its surplus or deficit. The government may offset undesirable variations in private consumption and investment by compensatory variations of public expenditures and taxes. Arthur Smithies defines fiscal policy as “a policy under which the government uses its expenditure and revenue programmes to produce desirable effects and avoid undesirable effects on the national income, production and employment.” Though the ultimate aim of fiscal policy is the long-run stabilization of the economy, yet it can be achieved by moderating short-run economic fluctuations. In this context, it can be defined as “changes in taxes and expenditures which aim at short-run goals of full employment and price-level stability. The following are the objectives of fiscal policy:

- (i) To maintain and achieve full employment.
- (ii) To stabilize the price level.
- (iii) To stabilize the growth rate of the economy.
- (iv) To maintain equilibrium in the balance of payments.
- (v) To promote the economic development of underdeveloped countries.

An increase in public expenditure during depression adds to the aggregate demand for goods and services and leads to a large increase in income via the multiplier process; while a reduction in taxes has the effect of raising disposable income thereby increasing consumption and investment expenditure of the people. On the other hand, a reduction of public expenditure during inflation reduces aggregate demand, national income, employment, output and prices; while an increase in taxes tends to reduce disposable income and thereby reduces consumption and investment expenditures. Thus, the

government can control deflationary and inflationary pressures in the economy by a judicious combination of expenditure and taxation programmes. For this, the government follows compensatory fiscal policy.

### **3.3.1 Compensatory Fiscal Policy**

The compensatory fiscal policy aims at continuously compensating the economy against chronic tendencies towards inflation and deflation by manipulating public expenditures and taxes. It, therefore, necessitates the adoption of fiscal measures over the long-run rather than once-for-all measures at a point in time. When there are deflationary tendencies in the economy, the government will increase its expenditures through deficit budgeting and reduction in taxes. This is essential to compensate for the lack in private investment and to raise effective demand, employment, output and income within the economy.

On the other hand, when there are inflationary tendencies, the government reduces its expenditures by having a surplus budget and raising taxes in order to stabilize the economy at the full employment level. The compensatory fiscal policy has two approaches vis: Built-in stabilizers and discretionary fiscal policy. The technique of built-in stabilizers involves the automatic adjustment of the expenditures and taxes in relation to cyclical upswings and downswings within the economy without deliberate action on the part of the government. Under this system, changes in the budget are automatic and hence this technique is also known as one of automatic stabilization. The various automatic stabilizers are corporate profits tax, income tax, excise taxes, old age survivors and unemployment insurance or relief payments. As instruments of automatic stabilization, taxes and expenditures are related to national income. Given an unchanged structure of tax rates, tax yields vary directly with movements in national income, while government expenditures vary inversely with variations in national income. In the downward phase of the business cycle when national income is declining, taxes which are based on a percentage of national income automatically decline, thereby reducing the tax yield. At the same time, government expenditures on unemployment relief and social security benefits automatically increase. Thus, there would be an automatic budget deficit which would counteract deflationary tendencies. On the other hand, in the upward phase of the business cycle when national income is rising rapidly, the tax yield would automatically increase with the rise in tax rates. Simultaneously, government expenditures on unemployment relief and social security benefits automatically decline. These two forces would automatically create a budget surplus and thus inflationary tendencies would be controlled automatically. Built-in stabilizers have the following advantages as a fiscal device:

- (i) The built-in stabilizers serve as a cushion for private purchasing power when it falls and lessen the hardships on the people during deflationary period.
- (ii) They prevent national income and consumption spending from falling at a low level.
- (iii) There are automatic budgetary changes in this device and the delay in taking administrative decisions is avoided.
- (iv) Automatic stabilizers minimize the errors of wrong forecasting and timing of fiscal measures.
- (v) They integrate short-run and long-run fiscal policies.

However, the limitations of built-in stabilizers include:

- (i) The effectiveness of built-in stabilizers as an automatic compensatory device depends on the elasticity of tax receipt, the level of taxes and flexibility of public expenditures. The greater the elasticity of tax receipts, the greater will be the effectiveness of automatic stabilizers in controlling inflationary and deflationary tendencies. But the elasticity of tax receipts is not so high as to act as an automatic stabilizer in many countries.

- (ii) With low level of taxes even a high elasticity of tax receipts would not be very significant as an automatic stabilizer doing a downswing.
- (iii) The built-in stabilizers do not consider the secondary effects of stabilizers on after-tax business incomes and of consumption spending on business expectations.
- (iv) This device is silent about the stabilizing influence of local bodies, state governments and of the private sector economy.
- (v) They cannot eliminate the business cycles but can reduce its severity at most.
- (vi) Their effects during recovery from recession are unfavourable. Economists, therefore, suggest that built-in stabilizers should be supplemented by discretionary fiscal policy.

Discretionary fiscal policy requires deliberate change in the budget by such actions as changing tax rates or government expenditures or both. It may generally take three forms vis: changing taxes with government expenditure constant, changing government expenditure with taxes constant, and variations in both expenditures and tax simultaneously.

When taxes are reduced, while keeping government expenditure unchanged, they increase the disposable income of households and businesses. This increase private spending. But the amount of increase will depend on whom the taxes are cut, to what extent, and on whether the taxpayers regard the cut temporary or permanent. If the beneficiaries of tax cut are in the higher middle-income group, the aggregate demand will increase much. If they are businessmen with little incentive to invest, tax reductions are temporary. This policy will again be less effective. Thus, this is more effective in controlling inflation by raising taxes because high rates of taxation will reduce disposable income of individuals and businesses thereby curtailing aggregate demand.

The second method is more useful in controlling deflationary tendencies. When the government increases its expenditure on goods and services, keeping taxes constant, aggregate demand goes up by the full amount of the increase in government spending. On the hand, reducing government expenditure during inflation is not so effective because of high business expectations in the economy which are not likely to reduce aggregate demand.

The third method is more effective and superior to the other two methods in controlling inflationary and deflationary tendencies. To control inflation, taxes may be increased and government expenditure be raised to fight depression.

The limitations of discretionary fiscal policy include:

The discretionary fiscal policy depends upon proper timing and accurate forecasting. Accurate forecasting is essential to judge the stage of cycle through which the economy is passing. It is only then that appropriate fiscal action can be taken. Wrong forecasting may accentuate rather than moderate the cyclical swings. Economics is not an exact science in correct forecasting. As a result, fiscal action always follows after the turning points in the business cycles.

There are delays in proper timing of public spending. In fact, discretionary fiscal policy is subject to three-time lags vis:

- (a) There is the “decision lag,” the time required in studying the problem and taking the decision. The lag involved in this process may be too long.
- (b) Once the decision is taken, is an “execution lag.” It involves expenditure which is to be allocated for the execution of the programme. In a country like the USA it may take two years and less than a year in the U.K and more in a developing economy like Nigeria.

- (c) Certain public work projects are so cumbersome that it is not possible to accelerate or slow them down for the purpose of raising or reducing spending on them.

Despite the higher multiplier effect of government spending as against changes in tax rates, the latter can be operated more promptly than the former. Emphasis has thus shifted to taxation as the best fiscal device for controlling cyclical fluctuations. Thus, when the turning point of a business cycle is already underway, discretionary fiscal action tends to strengthen the built-in stabilizers which has been the experience of developed countries like the USA.

### **SELF ASSESSMENT EXERCISE**

Write short note on taxation as a stabilization policy tool.

### **3.2 Budgetary Policy – Contra – cyclical Fiscal Policy**

The budget is the principal instrument of fiscal policy. Budgetary policy exercises control over size and relationship of government receipts and expenditures. The common budgetary policies that can be adopted for stabilizing the economy are discussed below.

- (i) **Budget Deficit—Fiscal Policy during Depression:** Deficit budgeting is an important method of overcoming depression. When government expenditures exceed receipts, larger amounts are put into the stream of national income than they are withdrawn. The deficit represents the net expenditure of the government which increases national income by the multiplier times the increase in net expenditure. Thus, the budget deficit has an expansionary effect on aggregate demand whether the fiscal process leaves marginal propensities unchanged or whether a redistribution of disposable receipts occurs.

Budget deficit may also be secured by reduction in taxes and without government spending. Reduction in taxes tends to leave larger disposable income in the hands of the people and thus stimulates increase in consumption expenditure. This, in turn, would lead to increase in aggregate demand output, income and employment. However, reduction in taxes is not so expansionary via increased consumption expenditure because the tax relief may be saved and not spent on consumption. Businessmen may not also invest more if the business expectations are low. To safeguard against such eventualities the government needs to follow the policy of reduction in taxes with increased government spending and its multiplier effect will be much higher in case some consumption and investment expenditures increase due to tax relief.

- (i) **Surplus Budget—Fiscal Policy during Boom:** Surplus in the budget occurs when the government revenues exceed expenditures. The policy of surplus budget is followed to control inflationary pressures within the economy. It may be through increase in taxation or reduction in government expenditure or both. This will tend to reduce income and aggregate demand by the multiplier times the reduction in government or/and private consumption expenditure (as a result of increased taxes).

**(ii) Balanced Budget:** Another expansionary fiscal policy is the balanced budget. In this policy the increase in taxes ( $\Delta T$ ) and in government expenditure ( $\Delta G$ ) are of equal amount. This has the impact of increasing net national income. This is because the reduction in consumption resulting from the tax is not equal to the government expenditure. The basis for the expansionary effect of this kind of balanced budget is that a tax merely tends to reduce the level of disposable income. Therefore, when only a portion of disposable income is used for consumption purposes, the economy's consumption expenditure will not fall by the full amount of the tax. On the other hand, government expenditure increases by the full amount of the tax. Thus, government expenditure rises more than the fall in consumption expenditure due to tax and there is net increase in national income. The balanced budget theorem is based on the combined operation of the tax multiplier and the government-expenditure multiplier. In this, the tax multiplier is smaller than the government-expenditure multiplier.

### **SELF ASSESSMENT EXERCISE**

Discuss different types of fiscal policy.

### **3.3 Effects of Taxation**

We have already understood the meaning of incidence of taxation. It refers to the direct money burden of a tax. The ultimate influence of taxation on economic entities like production, consumption, distribution etc. is referred to as effects of taxation. In a wider perspective, taxation can serve as an instrument of fiscal policy in realizing socio-economic goals like price stabilization, regulation of consumption and production, checking fluctuations of booms and depression, promoting economic growth etc. However, the economic effects of taxation need not be always good, they can be bad also. Therefore, while formulating a tax policy, the government should take into consideration not only the revenue but also the economic consequences of taxation as well. According to Professor Dalton "The best system of taxation from the economic point of view is that which has the best or the least bad economic effects." He discussed three types of economic effects of taxation vis: the effects of taxation on production, effects of taxation on distribution and other effects of taxation.

#### **3.3.1 Effects of Taxation on Production**

According to Dalton the effects of taxation on production can be in the following three ways.

a) **Effects on ability to work, save and invest:** Being transfer of purchasing power from individuals to governments, taxation leads to the reduction of purchasing power of the individual tax payers. This will lead to the reduction of income, consumption, saving etc. of the people. This will adversely affect the efficiency and ability to work of the tax payers. This effect is mostly felt by the poorer sections of the society, since their propensity to consume is reduced. This will in turn lower their standard of living and as a result their efficiency and ability to work. On the hand, the efficiency and ability to work of the richer people is not affected by taxation, as taxation will result in the reduction of their conspicuous and luxurious consumption. On this ground heavy taxation on the poorer people is objected by most of the economists.

The effect of taxation on ability to work depends on the nature of tax. There are some taxes which will promote the ability and willingness to work of the people, like taxes on commodities such as tobacco, intoxicating drugs etc. Taxes will reduce the consumption of such goods, which are detrimental to health and efficiency. Saving depends on income. So, when there is a fall in income as a result of taxation, saving is reduced which will affect investment. The ability to work, save and invest is affected by all types of taxes.

b) **Effects on willingness to work, save and invest:** The effects of taxation on the willingness, save and invest is partly determined by the monetary burden of tax and partly by the psychological state of the tax

payer. That is, the nature of taxes and psychological reaction of the tax payers. Some taxes like tax on windfall gains, inheritance tax, tax on monopoly profit etc. will have no bad effects at all on the willingness to work, save and invest. Similarly, reasonable commodity taxes like excise duty, sales tax etc. will not affect willingness to work, save and invest adversely. Direct taxes like personal income tax will influence the willingness to work, save and invest adversely but indirect taxes being included in the prices may not have such disincentive effects. Also, the immediate effect on the mind of the tax payer on the announcement of a new measure of taxation is called the psychological reaction. A.C. Pigou called this as “**announcement effect of taxation.**” It implies a change in the mental state of tax payer by the imposition of a new tax or by the withdrawal of an old tax or by variations in the existing tax rates. The psychology of the tax payer depends on the elasticity of demand for income. If the demand for income is inelastic, the tax payer will work more to maintain the pre-tax level of income. The incentive to work, save and invest of such tax payers will not be adversely affected but instead be accelerated. If a person has an elastic demand, his incentive to work, save and invest may be retarded with the imposition of taxes. Similarly, if the demand is unity, the desire to work remains constant whatever the level of income.

c) **Effects of Taxation on Diversion of resources:** After the publication of ‘The General Theory’ by J.M. Keynes, the taxation policy has assumed great importance in influencing the economic welfare of the people. A rational allocation of resources is essential for ensuring the economic welfare of the people. There are beneficial diversions of resources as well as harmful diversion of resources through taxation. Beneficial diversion is a powerful instrument to achieve rational allocation of resources through beneficial diversion of resources from undesirable uses to the most desirable ones from the social welfare point of view. For example, tax on luxuries, liquors, tobacco etc. Similarly, tax on luxury items and comforts can divert resources from their production to the production of necessities. Another way of resource diversion is done through differential tax system. On the other hand, taxation on necessities or articles of mass consumption may not be socially desirable. As a result of increase in prices of such articles, the demand will be decreased which will in turn reduce the production. Similarly, taxes on industries will harm rural and backward areas. Taxes on domestic industries will bring about shifting of domestic resources to foreign countries where the burden of tax is minimal or to such industries which are exempted from taxation. In short, resources are shifted from high taxed countries to low taxed countries. This constitute a harmful diversion of taxation.

d) **Effects of Taxation on Distribution:** Distributive justice is one of the macroeconomic goals of the government. Distributive justice implies that growth in the economy should be shared equally by all sections of the people. It also implies that inequalities of wealth and income should be greatly reduced through a proper, equitable distribution of income produced in the country. Taxation is regarded as an important means to reduce the inequality in income and wealth distribution. As Dalton pointed out, “Other things being equal, one tax system is preferable to another if it has a stronger tendency to check inequality.” Taxation is essential not only to collect surplus income from the rich but also to perform social welfare functions and to provide funds for uplifting the poorer sections of the community. In general, all direct taxes, falling heavily on the people getting higher income and possessing large amount of wealth, do have favourable effect on equalizing income and wealth. Progressive taxes on income and wealth found to be of immense use in bringing justice in the distribution of income and wealth. On the other hand, indirect taxes such as sales tax, excise duties etc. are imposed at higher rates, the lower and middle-income groups will adversely be affected. However, even in the case of indirect taxes equality can be maintained by resorting to higher rates of taxation on luxuries and semi-luxuries. While achieving favourable distributional effects through progressive taxation, care must be taken to ensure that the goose (rich people) that lays golden eggs (of savings and capital formation) does not die.

## 4.0 Conclusion

From our discussion in this unit we have been able to identify:

- The linkage between taxation and fiscal policy.
- How taxes are used as an instrument of stabilization
- Tax as a built-in stabilizer in controlling the economy
- The effects of tax on economy

## 5.0 Summary

The fiscal policy encompasses two separate but related decisions; public expenditures and the level and structure of taxes. It occupies the central place for maintaining full employment without inflationary forces in the economy. With its various instruments it influences the economic stability of an economy. This unit provided a detail discussion of the linkages between tax and fiscal policy. It also discusses stabilization policy, built-in stabilizer and tax as a tool of fiscal policy. It looks at different types of budget and how tax is manipulated to control inflationary and deflationary pressure. Finally, it discusses the effects of tax on the economy.

## 6.0 Tutor-Marked Assignment

Write a two-page note on tax as an instrument of fiscal policy.

## 7.0 References/Further Reading

- Kaplow, L. (2008), *The Theory of Taxation and Public Economics*, Princeton University Press.
- Stiglitz, J. (1999), *Economics of the Public Sector*, W.W. Norton & Company 3rd ed.
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<b>Module Three</b>	<b>Public Expenditure</b>
Unit 1	Public Expenditure: General Consideration
Unit 2	Evaluation of Public Expenditure
Unit 3	Public Expenditure and Fiscal Policy

## **Unit 1                    Public Expenditure: General Consideration**

### **CONTENTS**

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### **1.0 Introduction**

This module contains the expenditure aspects of government fiscal policy. The expenses incurred by the governments for its own maintenance, preservation and welfare of the economy as a whole is referred to as public expenditure. Government provides good and services in the economy and utilized resources to provide these goods and services. A discussion of government expenditure centered around different types of expenditures incurred by government and how these expenditures are used to control economic fluctuations. This module provides a general consideration of government expenditure. The first unit gives the general background of government expenditure. It introduced us to the different types of government expenditures, classification of public expenditure, canons of public expenditure and the effects of public expenditure in the economy.

### **2.0 Objectives**

At the end of this unit, students should be able to:

- (i) Understand the meaning and importance of public expenditure
- (ii) Understand classification of public expenditure
- (iii) Understand theories of growth of public expenditure
- (iv) Understand the effects of public expenditure in the economy

### **3.0 Main Content**

#### **3.1 Public Expenditure: Meaning and Importance**

Public expenditure refers to the expenses of public authorities-central, state and local governments in a federation-for the satisfaction of collective needs of the citizens or for promotion of economic and social welfare. The development functions include education, public health, social security, irrigation, roads, buildings, etc. The major cause of increase in the public expenditure are these developmental functions. Hence, the study of public expenditure has become very significant in the study of public finance. The two major reasons for the study of public expenditure are

- (i) increase in the economic activities of the government

- (ii) nature and volume of public expenditure have greatly affected the economic life of the country in a different manner. i.e., it has affected production and distribution and general level of economic activities.

The government was assigned a limited role to play in the laissez-faire era. The functions assigned to the state were based on the principle of least interference or 'that government is the best when spends the least.' The classical school of thought restricted the functions of the state to 'Justice, Police and Arms.' They considered government expenditure wasteful and that money could be used by private persons than by the government. Adam Smith in his magnum opus 'The Wealth of Nations' published in 1776 observed that the sovereign has three main duties to perform as:

- a) protect the society from violence and invasion of other independent societies
- b) protect against injustice
- c) build and maintain certain public works.

David Ricardo observed that 'If you want a peaceful government you must reduce the budget'. In recent time, public expenditure has increased immensely. The main reason is that the functions of governments have increased manifold. The modern states are no more police states but welfare states. Adolph Wagner, in his 'Law of Increase of State Activities,' states that 'comprehensive comparison of different countries and different times show that among progressive people with which alone we are concerned, an increase regularly takes place in the activity of both central and local governments.' This increase is both intensive and extensive.

Economists advocated public expenditure since a government provides many activities such as:

- (i) activities to secure a reallocation of resources
- (ii) redistribution activities
- (iii) stabilizing activities
- (iv) commercial activities.

Governments constantly undertake new functions while they perform both old and new functions more efficiently and completely. In this way the economic needs of the people, to an increasing extent and in a satisfactory fashion are satisfied by the government.

### **3.1.1 Causes of the Increase in Public Expenditure**

One of the most important features of the present era is the remarkable growth of public expenditure. Some of the important reasons for the growth of public expenditure are:

- (i) Welfare State: Modern states are no more police states. They have to look in to the welfare of the masses for which the state has to perform a number of functions. They have to create job opportunities and other welfare activities. All these require huge expenditure.
- (ii) Defense Expenditure: Modern warfare is very expensive. Wars and possibilities of wars have forced nations to always equipped with arms which require large amount of public expenditure.
- (iii) Growth of Democracy: The present form of democratic government is highly expensive. The conduct of elections, maintenance of democratic institutions like legislatures etc. cause huge expenditure.
- (iv) Growth of Population: High growth of population requires huge spending on the part of the government. For meeting the needs of the growing population more educational institutions, food materials, hospitals and other amenities have to be provided.
- (v) Rise in Price Level: Rises in prices have considerably enhanced public expenditure in recent years. Higher prices mean higher spending on items like payment of salaries, purchase of goods and services and so on the part of the government.

- (vi) Development Expenditure: Implementing developmental programs like five-year plans, modern governments are incurring huge expenditure.
- (vii) Public Debt: Along with debt rises the problem like payment of interest and repayment of the principal amount. This results in an increase in public expenditure.
- (viii) Poverty alleviation programs: As poverty ratio is high, huge amount of expenditure is required for implementing alleviation programmes.

### **SELF ASSESSMENT EXERCISE**

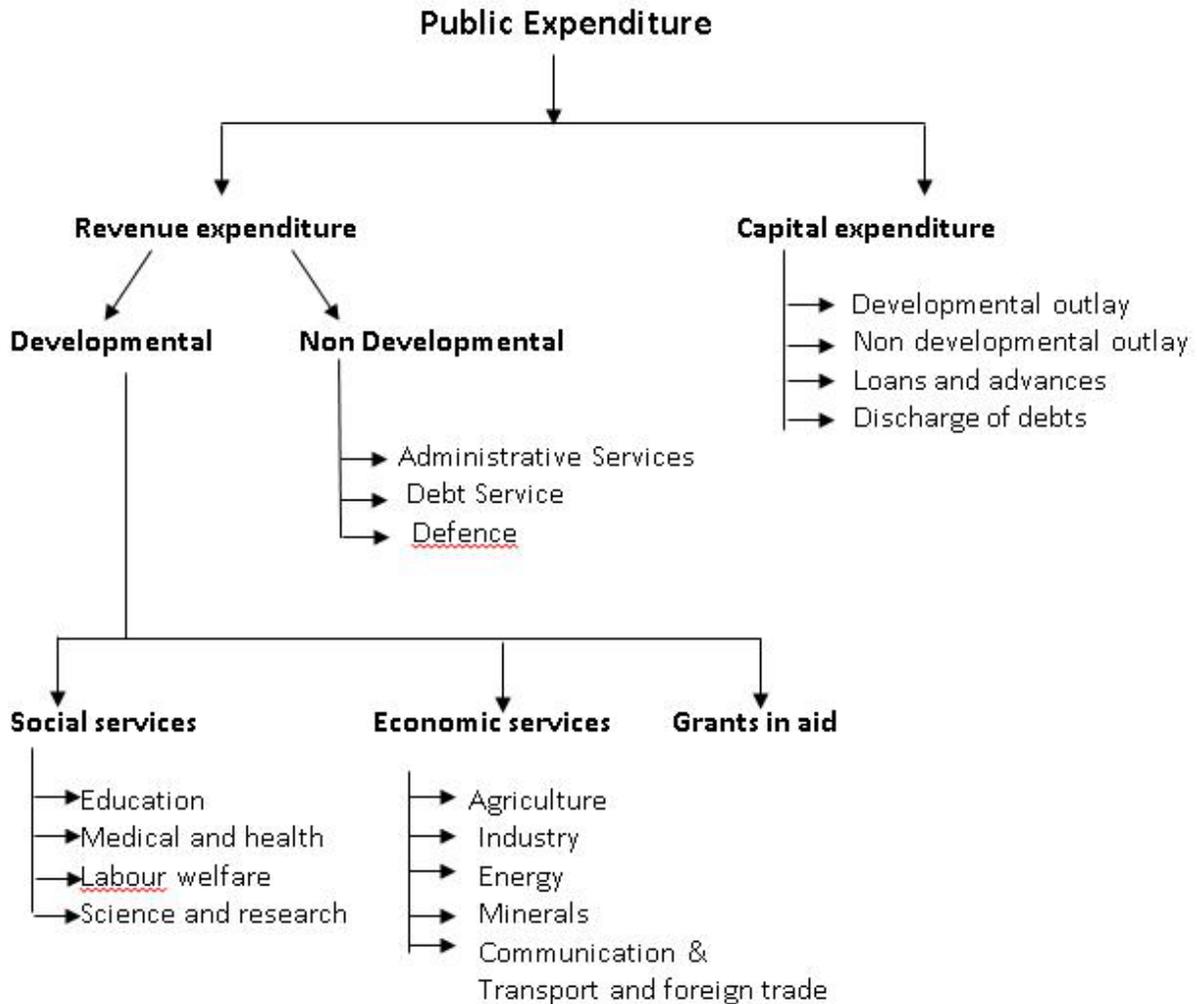
Discuss the meaning and importance of public expenditure.

### **3.2 Classification of Public Expenditure**

Public expenditure can be classified into (i) Revenue or recurrent expenditure and (ii) Capital expenditure.

Revenue expenditure is current expenditure. It includes administrative expenditure and maintenance expenditure. This expenditure is a recurring type. The recurrent expenditures are the expenses made by government in her purchase of current general goods such as services. These include the purchase of everyday goods such as materials, equipment (for recurrent consumption), the payment for rent, and such similar goods which entail running costs. They also include payment of salaries, and wages and other types of emoluments to government employees. Capital expenditure is of capital nature and is incurred once for all. It is non-recurring expenditure. Capital expenditures are expenses incurred by the government for the purpose of increasing future consumption and production. They can be regarded as expenses made on “capital goods” as distinct from “consumption goods” we are aware however that sometimes it is not easy to draw a line between these two types of expenditure when the expenses are made on certain durable goods. Example of capital expenditure include building multipurpose projects or on setting up big factories like steel plants, money spent on land, machinery and equipment.

Revenue Budget or Revenue Account is related to current financial transactions of the government which are of recurring in nature. Revenue Budget consists of the revenue receipts of the government and the expenditure is met from these revenues. Revenue Account deals with taxes, duties, fees, fines and penalties, revenue from government estates, receipts from government commercial concerns and other miscellaneous items, and the expenditure therefrom. Revenue expenditure includes interest-payments, defense expenditure, major subsidies, pensions etc. The Capital Account is related to the acquisition and disposal of capital assets. Capital budget is a statement of estimated capital receipts and payments of the government over fiscal year. It consists of capital receipts and capital expenditure. The capital account deals with expenditure usually met from borrowed funds with the object of increasing concrete assets of a material character or of reducing recurring liabilities such as construction of buildings, irrigation projects etc. Capital receipts include borrowings, recovery of loans and advances, disinvestments and small savings. Capital expenditure includes developmental Outlay, Non-developmental outlay, Loans and advances and Discharge of debts. This can be explained in figure 3-1 below:



### SELF ASSESSMENT EXERCISE

Discuss the main classification of public expenditure.

### 3.3 Theories of Growth of Public Expenditure

The three important theories of the growth of public expenditure are:

- (i) Adolph Wagner's hypothesis
- (ii) Peacock - Wiseman hypothesis and
- (iii) Colin Clark's Critical Limit Hypothesis.

#### 3.3.1 Adolph Wagner's Hypothesis

Adolph Wagner (1835-1917) held that there is a cause-effect relationship between economic growth and public expenditure. His hypothesis of 'Law of Increasing State Activity' state that as per capita income and output increase in industrialized counties, the public expenditure of those counties necessarily grows as a proportion to total economic activity. He explained that 'comprehensive comparisons of different countries and different times shows that among progressive people, with which alone we are concerned, an increase regularly takes place in the activity of both central and local governments. The increase is both extensive and intensive. The central and local governments constantly undertake new functions, while they perform both old and new functions more effectively and completely. 'He explained the trend of public expenditure as follows:

- a) As the national income increases, the percentage of outlay for government supplied goods is greater.
- b) Increased public expenditure was the natural result of economic growth and continued pressure for social progress.

### **3.3.2 Peacock - Wiseman Hypothesis**

According to Peacock and Wiseman, public expenditure does not increase in a smooth and continuous manner. The increasing public expenditure over time has occurred in a step-like manner. They studied the experience of the United Kingdom for a secular period (1890-1955). Instead of studying the trend of public expenditure, they studied the fluctuations in government expenditure over time. The general approach to the hypothesis refers to the three related concepts viz: displacement effect, inspection effect and concentration effect.

The movement from older level of expenditure and taxation to a new and higher level is called the displacement effect. War and other social disturbances force the people and governments to find solutions of important problems, which had been neglected earlier. This is called the inspection effect. That is, new obligations imposed on state, in the form of increased debt, interest and war pensions etc. The concentration effect refers to the apparent tendency for the central government economic activities to become an increasing proportion of the total public sector economic activity when the society is experiencing economic growth.

### **3.3.3 Critical Limit Hypothesis**

This hypothesis was developed by Colin Clark immediately after the Second World War. It is concerned with the tolerance level of taxation. By maximum limit, the tolerance level is 25% of GNP. When the share of government expenditure exceeds 25% in the GNP, inflation occurs even in balanced budget.

### **SELF ASSESSMENT EXERCISE**

Examine the growth of public expenditure in Nigeria within the framework of theories of public expenditure growth.

### **3.4 Canons of Public Expenditure**

The canons or principles of public expenditure are the fundamental rules which govern the public expenditure policy of the governments. The method and direction in which the public expenditure utilized is of paramount importance. Alfred G. Buchler made some rules for the utilization of expenditure by the public authorities as follows:

- (i) Public expenditure should promote the welfare of the society.
- (ii) Careful judgement should be exercised by the public authority and the electorate to ensure that the advantages of the public expenditure should exceed the costs and that the fund utilized by the governments will be more conducive to social welfare than the same funds would, if privately utilized.
- (iii) Public expenditure should be utilized in the order of priority of welfare. That is, the services which will bring about maximum welfare should be undertaken first.

The four canons of public expenditure are canon of benefit, canon of sanction, canon of economy and canon of surplus. Each of these are discuss as follows:

#### **3.4.1 Canon of Benefit**

This says that public expenditure should be planned so as to yield maximum social advantage and social welfare for the community as a whole and not of a particular group. The ideal of this is maximum social advantage. Public expenditure must be spent in those directions which will maximize utility. It is

possible only when the marginal utility from different uses is equal. The public authorities should distribute resources so as to increase production, reduce inequalities of income distribution and improve the quality of social life etc. Other things being equal, expenditure should bring with it important social advantages such as increased production, the preservation of the society against external attack and internal disorder and as far as possible a reduction in the inequalities of income. In short, public funds must be spent in those directions most conducive to the public interest. i.e., maximum utility is to be attained in public expenditure.

### **3.4.2 Canon of Economy**

This implies that the state should be economical in spending money. The state should not spend more than the necessary amount on items of expenditure. The sole aim is to avoid extravagance and corruption. Social benefit can be maximized when resources are not wasted. While incurring public expenditure social costs are to be minimized. To satisfy this canon project appraisal and cost-benefit analysis should be done. Economy means protecting the interests of the tax payers not merely in effecting economies in expenditure, but in developing revenue.

### **3.4.3 Canon of Sanction**

According to this canon, no expenditure should be incurred without the proper approval of the approving authority. It also implies that the spending authorities should spend the amount for which it has been sanctioned and to see that the approved amount is properly utilized. Public accounts are to be audited at the end of financial year. This canon acts as a check on arbitrary, imprudent and reckless spending of public funds.

### **3.4.4 Canon of Surplus**

This canon believes in the avoidance of deficit in public expenditure. According to Findlay Shirras, Public authorities must earn their living and pay their way like ordinary citizens. Balanced budget must, as in the private expenditure; be the order of the day. Annual expenditure must be balanced without the creation of fresh credits unrepresented by the new assets. Modern governments do not consider balanced budget a virtue always. In an inflationary condition a surplus budget is desirable as it reduces purchasing power of the individuals. Similarly, in the time of depression a deficit budget is recommended in order to enhance the purchasing power of the people. The canon of surplus is not relevant in modern public finance.

### **3.4.5 Other Canons of Public Expenditure**

- a) **Canon of Productivity:** Public expenditure should promote production and increase the working efficiency of the people. Major part of public expenditure should be incurred on developmental activities. The aim of public expenditure should be maximum production, employment and income.
- b) **Canon of Elasticity:** There should be flexibility in government expenditure. That is, the government should be able to change its public expenditure policy with changing conditions. It means that public expenditure should increase during periods of emergency and reduce during normalcy.
- c) **Canon of Equality:** This implies that public expenditure should be incurred in such a way that inequality in the distribution of income should be reduced. The benefit of public expenditure should confer more on the poorer section of the society.
- d) **Canon of Neutrality:** Public expenditure should not worsen the production-distribution-exchange relationship. Public expenditure should result in increased production and productivity, reduced inequality of income and wealth and increased economic activity and exchange relationship.

- e) **Canon of Certainty:** The public authorities should clearly know the purposes and extent of public expenditure to be incurred. This canon explains the preparation of public budgets.

#### **4.0 Conclusion**

From the discussion above we have been able to identified that:

- the meaning and importance of public expenditure
- the classification of public expenditure
- the theories of public expenditure
- the canon of public expenditure

#### **5.0 Summary**

This unit introduced us to the meaning, importance and classification of public expenditure. It gives a description of the theories of government expenditure growth and the canon of public expenditure. This is to further exposes the context of the fiscal policy.

#### **6.0 Tutor-Marked Assignment**

Submit a two-page essay on public expenditure in any economy.

#### **7.0 References/Further Reading**

Kaplow, L. (2008), *The Theory of Taxation and Public Economics*, Princeton University Press.

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## **Unit 2**

## **Evaluation of Public Expenditure**

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- 3.0 Main Content
  - 3.1 Framework for Analyzing the Composition of Expenditures
  - 3.2 Analyzes of the Functional Composition of Expenditures
  - 3.3 Analyzes of the Economic Composition of Spending
  - 3.4 Cost Benefit Analysis
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

### **1.0 Introduction**

Evaluation has become one of the elements recognized in many governments for public resource allocation and management. There has been keen concern about the allocation of public expenditures in developing countries in recent years. Forced by macroeconomic imbalances to cut aggregate spending governments have been faced with difficult choices about how to restructure the composition of spending to meet aggregate fiscal targets and donors have also placed increasing emphasis on evaluating public expenditures that they are directly or indirectly financing This unit presents a framework for evaluating the overall level and composition of expenditures and how this framework can be applied to analyzing broad allocations of spending within and across sectors such as education, health, agriculture etc.

### **2.0 Objectives**

At the end of this unit, students should be able to:

- (i) Understand framework for analyzing public expenditure
- (ii) Understand analyzes of the functional composition of public expenditure
- (iii) Understand analyzes of the economic composition of public expenditure
- (iv) Understand cost-benefit analyses of public expenditure

### **3.0 Main Content**

#### **3.1 Framework for Analyzing the Composition of Expenditures**

The starting point for evaluating the composition of public spending is the evaluation of the aggregate level of spending. The aggregate level of spending must be consistent with the macroeconomic framework to avoid rising budget deficits in particular macroeconomic imbalances depend upon how they are financed. For instance, if public spending is finance through excessive external borrowing, it can lead to a debt crisis; excessive use of foreign reserves leads to crises in the balance of payments; printing money excessively leads to inflation and too much domestic borrowing leads to higher real interest rates and crowding out of the private sector. Evidence shows that stable and low fiscal deficits have been associated with higher growth, investment and current account balances. The permissible

aggregate level of spending depends on the sustainable budget deficit and the composition of that deficit. To calculate the sustainable deficit, future projections of debt to GDP, the desired inflation rate, the real interest rate, and the growth rate of the economy need to be made.

In analyzing the sustainability of the deficit, the definition of the public sector needs to be as comprehensive as possible, particularly if a significant part of the public-sector deficit is borne by other levels of government or even the financial sector. The consolidated deficit can be calculated by adding the deficits of the various types of public entities, excluding transfers among these entities. In principle, this should include central government and other levels of governments particularly in federal structure. Such consolidation will be constrained by available data in many countries. However, failure to consolidate key components can utterly distort the macroeconomic consistency of the expenditure framework. Given a sustainable deficit, the composition of that deficit-i.e., the revenue-expenditure mix-needs to be analyzed.

In evaluating the composition of the deficit, the sustainable revenue can be calculated as the revenue consistent with the tax structure with minimum distortionary costs, or consistent with revenues of other countries with similar tax structures. However, the maximum permissible spending that results as a residual from the sustainable deficit and revenue need not be optimal if it crowds out more efficient private sector spending. For instance, the assessment of the role of government versus the private sector within and across sectors can plausibly reveal that aggregate spending can be reduced even below its maximum permissible level. Consequently, the aggregate level of spending must result from an iteration between the maximum permissible spending and the analysis of the social desirability of the composition of that spending using the criteria governing expenditure choice

The composition of public expenditures should finance the mix of goods and services that maximize social welfare. In principle, this implies that the present or proposed allocations of expenditures be assessed using three-step criteria for expenditure choice. The first two correspond to the efficiency criterion, while the third is concerned with equity.

(i) First, is there is a rationale for government intervention in general and public expenditure in particular in the area to address underlying market failures? Public expenditures should be concentrated first on goods and services that the private market will not provide or provide too little, rather than merely substituting for or improving upon the private market outcome. This requires identifying the characteristics of demand and supply to assess whether there are specific market failures (e.g., public goods, extremality, non-competitive market) causing the private market outcomes to deviate from socially desirable ones. The type of market failure will indicate the scope for private financing and delivery, and whether government intervention should take regulation, financing or outright provision. For instance, while economic principles would suggest that pure public goods (i.e., zero marginal cost of additional consumption) be financed wholly by the public sector, several other publicly-provided goods and services provide at least some private benefits which can be recovered from the private sector, albeit with subsidies to achieve socially desirable outcomes (e.g. for positive extremality, to cover losses from decreasing cost industries where marginal cost is below average cost). Consequently, the scope for private sector financing and/or delivery, together with concomitant reforms in the pricing and regulatory framework needs to be fully evaluated as a principal, initial criterion in screening public expenditure allocations.

(ii) Second, if there is an underlying market failure, how large is the discrepancy between social and private values this imposes and therefore how much can alternative expenditure allocation (including subsidies from pricing policy) improve upon the private market? In other words, the social cost-benefit of alternative expenditure allocations needs to be computed to select those that maximize the net contribution to social welfare. This requires information on the determinants of demand (e.g.

willingness to pay, price elasticity of demand, consumer ignorance externalities) and supply (e.g., size of private sector, performance substitutability between public and private sectors) to measure the net social impact of expenditure allocations (including subsidies resulting from pricing policies) on private consumption and supply. Consequently, the outcomes of alternative expenditure allocations or inputs (net of their impact on private supply, if any) need to be identified and the social valuation of alternative outcome-input combinations need to be compared. The traditional theory of public finances ought to evaluate expenditures using shadow prices to value inputs and outcomes.

(iii) Third, since cost-benefit analysis has traditionally not taken distributional weights into account, the impact on the poor of alternative expenditure allocations needs to be taken into account to ensure that the composition of spending helps meet the poverty alleviation objectives. This can be accomplished through various methodologies. One commonly used method is benefit-incidence analysis, which uses household surveys to rank everyone by some measure of well-being (e.g., consumption, income), estimates the average use of the relevant public service, uses public expenditure on that service as the proxy for benefits received and thereby attempts to compare well-being before and after the intervention. It is important to underscore however, that many incidence analyses have important limitations. The costs of programmes are an inadequate proxy for benefits received and these studies typically do not take into account the total costs of expenditure programmes, including administrative costs, participation costs of the poor and other behavioural responses. However, behavioural approaches can be quite demanding on data, and the usual benefit incidence analyses constitute a useful, first approximation.

In practice, applying the above criteria to the scope of public expenditure allocations is infeasible. Indeed, given information and capacity constraints in most developing countries, it would be impossible to rigorously apply these criteria to any meaningful fraction of the capital investments and recurrent programmes that comprise a country's overall expenditure programme. The principal challenge therefore lies in choosing the level and scope of analysis consistent with available information and capacity, and which nevertheless provides useful insights for expenditure analysis.

In analyzing the functional composition of expenditures, it is important to ascertain the constitutional division of functional responsibilities among various levels of government (i.e., unitary, federal, confederal), which will have a critical bearing on the nature of expenditure analysis. For instance, a federal form of government has a multi-tier structure of decision making, with the national government deciding about national public goods (defense), and subnational governments having independent or concurrent responsibility about local public services (e.g., basic health, primary and secondary education). Economic theory suggests that such decentralized decision making can in principle enhance allocative efficiency and social welfare because lower levels of government may be better able to map expenditures to meet local preferences, provided economies of scale and benefit-cost spillovers have been taken into account. In such structures, it becomes imperative to analyze not only the assignment of expenditure functions and tax revenues across levels of government, but also the efficiency and equity implications of the design of intergovernmental fiscal transfers (e.g., block grants, specific-purpose grants, matching grants) to offset vertical and horizontal imbalances, interjurisdictional spillovers.

### **SELF ASSESSMENT EXERCISE**

Discuss the main three-step analysis for determining expenditure choice.

### **3.2 Analyses of the Functional Composition of Expenditures**

The functional composition consists of allocations across and within sectors, such as education, health, transport, defense. Starting from the highest level of aggregation, expenditure analysis needs to inform how a given aggregate level of spending should be allocated across sectors (i.e., intersectoral

allocations) to maximize social welfare. This would imply carrying out the three-step analysis above for sectoral expenditures. However, applying the three criteria to aggregate sectoral expenditures suggest that only limited analysis of allocations across sectors, or intersectoral allocations can be made without first analyzing allocations within sectors, or intra-sectoral allocations. While public expenditures in a sector such as industry are inappropriate because they finance the production of private goods without underlying market failures, the analysis is more complicated for other aggregated sectoral expenditures. This is because a sector contains expenditures with very different public-private roles, net benefits and impact on the poor. Consequently, it becomes difficult to analyze relative allocations across sectors, without analyzing relative allocations within sectors. In this context, a programme as a set of expenditures within or across a sector with relatively homogeneous benefits constitutes a useful unit of analysis.

Given large interdependencies and externalities across sectors (e.g., mother's education improves children's nutrition), a programme could be a multi-sectoral set of expenditures aiming to achieve a particular set of benefits (e.g., reduced infant mortality, or integrated child development). The analysis of intersectoral allocations can be informed by intra-sectoral analysis. Therefore, analyzing intra-sectoral allocations entails:

- (i) identifying and assessing major sectoral programs based on the nature of underlying market failures and their public-private rationales;
- (ii) comparing the social cost-benefit across programs based on the outcomes associated with different program expenditures and where feasible, the social valuation of outcomes-expenditure combinations;
- (iii) comparing the impact of major programme expenditures on the poor; and
- (iv) analyzing key capital and recurrent expenditure within programmes using the same three criteria above.

Intra-sectoral analysis can therefore identify programmes within sectors that have a legitimate rationale for public expenditures, and alternative combinations of program expenditures and sectoral outcomes. This can be used to inform intersectoral analysis or the mix of sectoral expenditures and outcomes that maximize social welfare.

By illustrating the application of the above framework to intra-sectoral expenditure analysis in health, key programmes can first be identified based on the nature of the underlying market failure. In particular, public health programmes that provide public goods and large externalities (e.g., safe water, sanitation, vector control, control of infectious diseases) against those that provide private benefits (e.g., curative or clinical services) can be identified. Within the latter, basic clinical services (e.g., treatment of infection and pain, prenatal and delivery care) can be distinguished from advanced, tertiary care (e.g., specialized intensive care), because of the distinct nature and incidence of benefits they provide.

Applying the second criteria-social cost-benefit analysis-first requires identifying the impact of different programme expenditures on health sector outcomes. Key health sector outcomes of concern in developing countries typically consist of improved health status, measured for instance by reduced infant and maternal mortality rates. Establishing the relationship between programme expenditures and health outcomes is problematic because health outcomes can be a function of many other factors than mere government expenditures. Even given a relationship between programme expenditures and outcomes, carrying out cost-benefit analysis of health expenditures poses difficult and impossible challenges in the short run. A key problem lies in valuing the benefits from improved health. Such an analysis necessitates the analytically and ethically problematic issue of placing a value on life saved. These shortcomings have led to the use of cost-effectiveness as the criterion for choosing among health

programs. The economic composition of health expenditures in many countries reveal common patterns of input-mix imbalances, such as the inadequate funding for recurrent costs of continued investments in hospitals and health facilities and the crowding out of non-wage items by wage expenditures.

In education, different levels and types of instruction- primary, secondary, and tertiary education as well as vocational and technical education-can be taken as the major programmes for analysis. They are characterized by different underlying market failures, nature of benefits provided and impact on the poor. Given mounting evidence about the significant externalities from female primary education, this should constitute another important unit of analysis, if corresponding data are available. Applying the first criterion for expenditure choice across these programmes suggest that the rationale for government intervention is much more compelling for primary versus tertiary education because of the generally accepted, large social extremality from basic literacy which make the return to society as a whole larger than the return to individuals. The second criterion-cost-benefit analysis-has been extensively applied in education based upon wage differentials on account of different levels of education. The problem, however, is that the literature has not been able to measure the net additional social benefits or externalities. Regarding expenditure-incidence numerous studies conclude that expenditures on primary and secondary education are more pro-poor than tertiary education.

Economic infrastructure over a wide array of services, ranging from public utilities such as power and telecommunication public works such as roads, and other transport services such as railways and ports. The public sector has traditionally had a dominant role in the financing and delivery of infrastructures services. However, applying the first criteria above would suggest that the nature of market failures and the associated rationale for public expenditures are not compelling anymore in some infrastructure subsectors because of new technology and changes in regulatory management of markets. Applying the framework of expenditure choice to the road sector suggests that major road types or programmes can first be identified based on the nature of the underlying market failure. Rural and uncongested inter urban roads are typically non-excludable as well as nonrival because adding another driver does not reduce the value to someone else. These therefore constitute public goods with a strong rationale for public provision. Applying the third criteria-impact on the poor-has proven quite difficult in roads because of their public goods characteristics. It becomes difficult to attribute the indirect benefits of roads across income groups and benefit-incidence has therefore not been carried out as in health or education.

### **3.2.1 Analyzes of Intersectoral and Inter-programme Allocations**

Given intra-sectoral expenditure analysis as above, what expenditure allocations across sectors, or intersectoral allocations, will maximize social welfare? The literature has primarily attempted to evaluate intersectoral allocations by examining their relationship with economic growth using evidence from cross-country, time-series regression analysis. But there is a lack of consensus among these studies even about the direction of impact of key expenditure categories (e.g., positive or negative impact of the share of health, education and transport spending). There is also controversy about the often-presumed negative impact of defense spending. Indeed, several studies show that defense spending has generally not been associated with lower rates of economic growth. Other studies have attempted to evaluate the impact of the stock of capital (human and physical) and growth. Here, there is consensus on a positive impact of human and physical capital on growth, but uncertainty about its magnitude. A more fundamental problem in relying upon such studies is that they analyze the growth implications of aggregate sectoral expenditures, which consist of very heterogenous expenditure programs. Additionally, such cross-country studies present evidence about the "average" impact, and it is infeasible to control for the myriad of factors that determine marginal returns of particular intersectoral allocations across countries at different points in time.

This conclusion is reinforced if one examines the presumed negative impact of defense spending. There is much controversy about the positive versus negative impact of defense spending on growth. An analysis found that there is a quadratic relationship between military spending and growth; defense contributes to growth up to a certain point, beyond which it is detrimental. This depends on neighbours military spending which is the most important determinant of a country's military spending. This does not imply that defense spending in several countries may not be unproductive rather, it says that it is difficult to say whether defense spending is always unproductive or even whether there is an across-the-board international. This implies that the first step in intersectoral or inter-programme allocation should be to channel resources to those programs the private sector cannot undertake, and away from programs that constitute the comparative advantage of the private sector.

This brings up the second criterion for inter-programme expenditure choice-i.e., cost-benefit analysis is a cross to these alternative combinations A key problem is that it is more difficult to compare and value programmes across sectors than within sectors. This suggests that a three-step analysis be carried out. First, the analysis would need to identify alternative combinations of programme and locations and their corresponding outcomes (e.g., infant and maternal mortality, quality and quantity of education road segments constructed and maintained in particular condition, increase in crop yields, reduction in external threat). Secondly, an attempt needs to be made to select those programme expenditure-outcome combinations that are most socially desirable. The central problem here is that it is difficult to measure and compare the benefits across programmes in key sectors. As a starting point, the government's stated objectives or key targeted outcomes could be taken as a starting point, and the results of intra-sectoral analysis could be used to identify the allocations across programs that achieve or improve upon these stated objectives. This could reveal for instance that intra-sectoral reallocation can improve on sectoral outcomes even without intersectoral reallocation in favour of that sector. However, the analysis can also reveal that there are insufficient resources to achieve the vector of medium-term outcomes in the government's objective function. Consequently, an attempt will need to be made to evaluate the tradeoffs between alternative combinations of program expenditures-outcome combinations to choose the mix of outcomes that would be most socially desirable. Measuring these benefits is complex and probably infeasible. Nevertheless, sensitivity analyses can be carried out using plausible ranges for values of outcomes from studies elsewhere (e.g., estimates of the value of life from developed countries of \$3 to 7 million), and transparent packages of input-outcome choices resulting from alternative inter-programme allocations can be presented to policymakers.

Third, where politically feasible, these input-outcome combinations can be subject to voting through the budgeting process, whereby ministers, legislators, interest groups and households will implicitly place social values on alternative bundles of public goods through the voting process and thereby simulate a political contingent valuation survey. The impact on the poor must be an integral and central element in the program expenditure-outcome combinations referred to above. Indeed, it is important to explicitly evaluate the impact of inter-programme allocations on the poor to identify those that meet the poverty alleviation objectives most cost-effectively. To reach the poor, it is important to target expenditure programmes that matter the most to the poor.

#### **SELF ASSESSMENT EXERCISE**

Briefly explain the important factors to be considered in analyzing the functional composition of expenditures.

### **3.3 Analyzes of the Economic Composition of Public Spending**

The previous discussion has provided a framework for analyzing the functional composition of expenditures, which includes analyzing the input-mix imbalances or the economic composition within

and across sectors. The important input-mix imbalances in the economic composition appear within and across sectors and programs that need to be analyzed and redressed. The economic composition includes

- (i) capital investments, and
- (ii) current or recurrent expenditures, which include wages and salaries, other goods and services (including non-wage operations and maintenance), interest payments and subsidies.

There may be patterns of under- and overspending for each of these categories which cut across sectors or functional categories in many developing countries. These include the bias toward new capital investments, the underfunding of non-wage, overstaffing of a poorly paid civil service. To correct these problems, it is essential to carry out an integrated analysis of the economic composition - capital/recurrent and wage/non-wage balances - within each major programme. This involves:

- (i) compiling data on the economic composition of major programmes;
- (ii) weeding out unproductive programmes using the criteria discussed earlier; and
- (iii) examining the capital/recurrent and wage/non-wage balance within each program.

The evaluation of civil service wages and salaries entails examining three key dimensions: the total wage bill, civil service employment and civil service pay, including average pay and the structure of pay scales. Some general assessment of whether the wage bill is excessive is based on broad indicators such as trends or international comparison in the ratio of personnel expenditures to total revenues or GDP. A more meaningful assessment requires examining whether there is underlying, excessive public employment or pay scales. Whether there is excessive or surplus civil service employment ultimately depends on the appropriate role of government within and across sectors. This involves identifying the major programmes where civil servants are employed, evaluating whether government spending on these programmes is justified and assessing the appropriateness of the wage/non-wage balance within these programmes. To undertake such an analysis, a key challenge in developing countries is getting data on the growth and breakdown of employment.

In evaluating civil service pay, it is important to take nonmonetary allowances into account. With this, trends in total civil service compensation over time as well as private sector comparators can be analyzed. These analyses can help identify actions for the reform of civil service pay and employment, which is central and vital for the efficiency and effectiveness of public spending. Reforms have focused on:

- (i) reducing employment through reducing ghost workers, voluntary and early retirement, freeze on new hiring, and retrenchment based on functional reviews or programme-level evaluation;
- (ii) using the savings from retrenchment to decompress salary scales, incorporate allowances into monetary pay, and raise real pay over time.

The evaluation of non-wage pay is a vital and integral element of the evaluation of the economic composition within major programs. A range of country experiences strongly indicates a reduction in these expenditures, a worsening of the wage/non-wage balance, and a marked deterioration in infrastructure and services, such as schools without teaching materials, clinics without drugs, and rehabilitated roads becoming impassable once again. The basis for this analysis is information on costs related to the activities undertaken. As with other categories in the economic composition, it is inappropriate to evaluate subsidies and transfers as an aggregate expenditure category. Consequently, the economic evaluation of each type of subsidy and transfer needs to be carried out separately.

### **3.3.1 Analyzes of Institutional Arrangements in the Public Expenditure Management System**

To improve public expenditure allocations, it is important to evaluate both the institutional arrangements-or rules of the game among key decision makers who allocate public spending-as well as the particular allocations themselves. In this context, it is important to evaluate underlying institutional processes and incentives, and support institutional reform to improve expenditure allocations on a sustained basis. This is similar to ensuring that the broader "policy environment" which determines expenditure allocations is appropriate rather than evaluating the desirability of individual expenditure allocations themselves.

The analytical framework for analyzing institutional arrangement in public expenditure management seeks to identify formal and informal rules in a country's public expenditure management system that influence or contribute to a vector of three key expenditure outcomes:

- (i) aggregate fiscal discipline or control of aggregate budget deficits and expenditures
- (ii) the prioritization or composition of this aggregate spending among sectors, programmes and projects to maximize social welfare; and
- (iii) technical efficiency in the use of resources.

Public expenditure management is characterized by four distinct but related theoretical problems that can impede the achievement of desirable outcomes along these three dimensions. Institutional arrangements can help redress these problems to some extent, and thereby improve expenditure allocations.

The first problem has to do with what is known as the tragedy of the commons. Disparate claimants on government spending – ministries, politicians', donors - view the budget as a common resource pool which they can dip into with little or no cost. The tragedy of the commons problem can be mitigated by basing the budget on a consistent and binding medium-term macroeconomic framework, articulation of a medium-term vision to build consensus about future benefits from current sacrifices, granting the central ministries a dominant position on decisions concerning aggregate spending and by establishing formal constraints on spending and borrowing.

The second is a problem of information asymmetries and high transactions costs which may impede an efficient mapping of expenditures by government with the preferences of individual and groups in civil society which constitute its power base. Institutional arrangements that can help reduce these transactions costs to better facilitate expenditure-preference mapping include

- (i) mechanisms to reveal demand of civil society about the preferred mix of outcomes or budgetary priorities (e.g., parliamentary discussions and oversight);
- (ii) mechanisms to build consensus among claimants about relative allocations
- (iii) transparency about the process of making budgetary allocations (including proposed allocations and their outcomes) as well as about the actual allocations and their outcomes in an accessible and timely manner; and
- (iv) mechanisms to penalize or reward the government for the expenditure allocations that are made. The decentralization of some expenditure decision making to local levels of government, who are generally accepted to possess better information about local preferences, could constitute another institutional arrangement to improve the expenditure preference mapping. However, whether local governments act in this manner will depend on whether they are held accountable for results, which in turn will be a function of the transparency of budget allocations and corresponding outcomes. In addition, given vertical

and horizontal imbalances in decentralized structures, the design of intergovernmental fiscal transfers will determine the incentives for local governments to allocate resources efficiently and equitably.

The third problem arises from information asymmetry and incentive incompatibility within the government hierarchy (e.g., the relationship between the central and line ministries) which can impede a socially desirable allocation and use of budgeted resources. In particular, the central ministries have to balance the macroeconomic constraints with allowing more flexibility by line ministries to capitalize on the latter's superior information for making disaggregated expenditure allocations. A medium-term expenditure framework (MTEF) can constitute an institutional mechanism to achieve this. An MTEF could provide line ministries with resource allocations within the aggregate resource envelope based upon strategic priorities, and then have them articulate the sectoral objectives, programmes and unit costs for achieving sectoral outcomes within their resource envelope. At the same time, for this to yield desired results, line ministries need to have incentives to allocate resources cost effectively, and departments and agencies will need to have incentives to use resources in a technically efficient manner. Line ministries, departments and agencies therefore need to be held accountable for the allocation and use of budgeted resources. Mechanisms for accountability would include financial accountability and audits, value for money audits, ex-post evaluations, performance-based contracts of chief executives, etc.

The fourth problem arises from perverse incentives that may stem from external, donor assistance in aid dependent developing economies. Line ministries are interested in donor projects as it alleviates their hard budget constraint. Since they do not bear the cost of this financing, they will accept the projects whether or not it fits within the sectoral strategy. The extent to which donors' project financing will be socially desirable will be a function of the extent to which it is based on accurate information about social preferences and the extent to which there is donor coordination to support a mutually consistent composition of expenditures.

The institutional mechanisms that have been identified above to address key problems characterize an ideal public expenditure management system. It must be emphasized that such a system requires certain preconditions. Where such conditions are only weakly present then some of the mechanisms may not be feasibly established. One precondition is a strong adherence of society to the rule of law. Where the rule of law is weak, rules are not likely to be effective no matter how well written and internally consistent they are. A related precondition is the freedom of the press. Publication of budget documents for public scrutiny and the results of surveys are biting only if the press is free to scrutinize them and raise questions about potential anomalies. But the press must also be responsible i.e., be able to support with evidence whatever it publishes. Otherwise its credibility is strained which would lower the cost of agency malperformance. And finally, an often-overlooked requirement is human capabilities. Some mechanisms require the use of skilled individuals, e.g., auditing, accounting or cost-benefit analysis.

### **SELF ASSESSMENT EXERCISE**

Describe the main ingredients of evaluation of the economic composition of public expenditure.

### **3.4 The Cost Benefit Analysis**

Cost Benefit Analysis (CBA) is the determination of government investment project. CBA originated from the field of water resources and emphasized investment in physical resources. Precisely – CBA seeks to take all the benefits and costs (direct and indirect) into consideration to evaluate alternative approaches as well in the overall project in light of the objectives

#### **3.4.1 Elements of CBA**

CBA studies are typically undertaken with a particular government department as a preliminary for budget preparation or as a continue programme to determine efficient expenditure pattern and budget recommendation. The steps involve in carrying out CBA are:

- (i) Statement of objectives
- (ii) The goals of the programme must be defined explicitly, because if it's not adequately defined it may not be amenable to CBA. Here, the concern is about the following question: What does the activities seek to attain in conformity to the overall objectives of the society of seeking the highest possible level of welfare? In this case the goal may be very specific such as irrigation project to bring say 2000 hectares of land under cultivation. There are projects which have multiple objectives and example of such contribution of dam. Dam may have flood control, irrigation even for navigation and recreational objectives. Others may have goals that may be very difficult to define specifically. If the goals of a project can be defined sharply, the project becomes easily amenable to CBA. However, the priority status assigned to a goal is not a question for CBA to answer, it is a political question.
- (iii) Statement of Alternatives: With many types of activities, there are various ways of attaining the goal. For example, having different facility for irrigation activities and different methods of construction. CBA seeks to determine relative benefit and cost of major alternatives.
- (iv) Analysis of Benefits: Once the objectives are defined and the alternatives established, next is to consider the benefit. Benefit may be defined as the present value of the time stream of benefit or contributions to the objectives. In determine the benefits how major questions are pertinent: what are the benefits to be included? how are the benefits to be valued?
- (v) Direct and Indirect Benefits: With many projects these are two types of benefits, there are those accruing to the users of the services provided. The indirect benefits or externalities are the benefits accrued to others. For example, rapid mass transit lines offer direct benefit to those who use it and at the same time an externality to others due to the reduced congestion for those who drives on the less crowded streets. The implication of this is that those who drives on the high ways will not spent long time on their journey. The indirect benefits are usually included, in the computation of total benefits at the theoretical level. But in practice only the major categories of benefits are included. In this regard, technologies benefits are included whereas pecuniary benefits are not included. If the building of an irrigation, dam, reduces flooding or provides more pleasant scenery for tourists driving pass the lake provided by the dam, these are real externality and will be included. However, pecuniary benefits in the form of reduced imports cost or increase volume of business and increase in lands value arising through the use of the service are not real externality and therefore will be excluded. Many of the pecuniary examples highlighted are distributional in nature and they benefit some persons at the expense of the others.

### **3.4.2 Valuation of Benefits**

The direct benefit of a project to the user can be computed on the basis of the amount the user is willing to pay. In other words, the revenue that can be obtained from the sales of the services with perfect discrimination. It should be acknowledged that there is valuation problem vis:

- (i) The activities which conveyed direct benefit but are exceedingly difficult to calculate or determined. An example of such is how much one is willing to pay for recreational activities?
- (ii) The existence of imperfection i.e there is lack of perfect competition in the market -implying that measure of benefit differ from one market to the other.

Apart from valuation difficulties, estimation of benefits is always coloured with uncertainty about future condition. Benefits from irrigation facilities will depend upon future trends; population and farms output.

### 3.4.3 Cost

Cost of the project may be defined as the present value of the resources that will be used in the project valued at their opportunity costs i.e. the amount that will be paid for them for alternative uses. There are also direct and indirect costs. Direct costs include capital cost, operative and maintenance costs over the years. Indirect costs include those created for other governmental agencies and overall cost to the society not directly borne by the government. These costs are in a sense negative benefits.

### 3.4.5 The Need for Discounting

Cost-Benefit Analysis is employed for long range project. Cost will be incurred currently and in the future. Benefits will be obtained over a number of years. Because of time preference, benefits in the subsequent years are of less importance than benefits in the current years. Costs incurred now are significant than costs incurred in later years because of the existence of interest rate. In this regard, some discounting methods must be used to adjust benefits and costs on the basis of the years they occurred.

### 3.4.6 Methods of Evaluation

There are three methods of evaluation:

- (i) Determination of the present value of the project: This involved discounting the net excess of benefit and cost (B-C) for each back to the present year.

If  $\{(B_T - C_T) / (1+r)^T\} \geq 0$  profitable  $\geq$  or  $\leq 0$ ;  $> 0$  is profitable and  $< 0$  is not profitable and  $= 0$  is breakeven. A project having the positive ( $> 0$ ) is justified. In other words, if funds are available, all such project which the net present value (NPV)  $> 0$  should be undertaken and not profitable to undertake any project which NPV  $< 0$  and if the NPV is equal to zero, you may decide to undertake the project or not.

- (ii) Benefit-cost Ratio: This involves discount benefit to the present value and discount cost to the present value. And the result will be discounted benefit over discounted cost. The rule is that  $B/C \geq 1$ , otherwise, if  $\leq 1$  it is not profitable.

- (iii) Internal Rate of Return (IRR): The internal rate of returns is the rate of return that will equate

the net benefit, over the life of the project with original cost i.e.  $\sum_{t=1}^T NB_t / \sum_{t=0}^T NC_t = C_0$ . The

problem here is what is that discount rate that will equate the B- C ratio to the initial cost. If the calculated  $R^* > SR$ , the project is profitable; If  $R^* < SR$ , the project is not profitable and if  $R^* = SR$ , then be indifferent. This method ranks various project but does not indicate which one is justified except by comparison with a social rate of discount. If there are no capital constraints and no project are mutually exclusive, all three criteria given the same result about justifiability of the project.

Under the first criterium, all projects will be undertaken with discounted benefit exceeds or equal to discounted cost. Under the B-C ratio, all projects whose B-C ratio  $\geq 1$  will be undertaken. Under the IRR criterium, all project will be undertaken, as long as their rate of return  $\geq$  social rate of discount.

The inspection of the first and second criteria indicated that they are equivalent for the marginal investment  $B = C$  implies  $B/C = 1$ . Some reflection will indicate that they are also equivalent to the third criterium (IRR). IRR is that rate which makes the discounted benefit equal to discounted cost. If the rate = social rate of discount, then the discounted benefit will be equal to discounted cost. Hence, you get the same result for all the three criteria. In the real-world capital is not available unlimited and projects are

often mutually exclusive. In this respect we have to choose among projects. In the first case, the best procedure is to maximize the discounted benefit subject to the existing capital constraint. The idea is to ensure that the most efficient combination of project is chosen. In government circle, some constraint is usually used to choose and this constraint is assumed to be  $> 1$ , and for any project greater than that constraint, it is assumed that such project is worthwhile to undertake. It must be said that the value of such constraint is usually unknown and by implication if a wrong constraint is chosen, it will lead to inefficient result.

There are three alternative interest rates that are usually used:

- (i) Marginal productivity of capital in private investment: This could be seen as an opportunity cost which may be defined as the amount of the fund the government borrow from private hand. This refers to typical earning of capital in private investment.
- (ii) Social rate of time preferences: This is the compensation that is necessary to induce consumer to refrain from consumption and save. In a riskless world, for example, the figure could be equal to the marginal productivity of capital.
- (iii) Government borrow rate without reference to time preference: This is the interest rate at which government can borrow without any effort to justify the figure with time preference. In a sense this is the direct cost to the government of obtaining the funds and thus, the risk element involved is that of the government not of lending to the private sector.

#### **4.0 Conclusion**

From the discussion in this unit we have been able to:

- Explain functional composition of public expenditure
- Explain economic composition of public spending
- Explain institutional factors involved in both functional and economic composition of public spending.
- Explain benefit-cost analyses of public project.

#### **5.0 Summary**

This unit explains evaluation of public expenditure from functional and economic composition perspective. It further discusses the institutional factors involved in this and also looks at the benefit and cost analysis of public project.

#### **6.0 Tutor-Marked Assignment**

Submit a two-page essay on evaluation of public expenditure.

#### **7.0 References/Further Reading**

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## **Unit 3**

## **Public Expenditure and Fiscal Policy**

### **CONTENTS**

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### **1.0 Introduction**

Fiscal policy is the use of government spending and taxation to influence the economy. Governments typically use fiscal policy to promote strong and sustainable growth and reduce poverty. The role and objectives of fiscal policy have gained prominence after great depression of 1936 as governments have stepped in to support financial systems, jump-start growth, and mitigate the impact of economic fluctuations on vulnerable groups. This unit explore how public expenditure are use to achieve fiscal policy of the government. It provides linkages among all the discussions in unit one and unit two and looks the at the impact of fiscal policy on different economic agents and economic activities.

### **2.0 Objectives**

At the end of this unit, students should:

- (i) Understand public expenditure and the working of fiscal policy
- (ii) Understand different expenditure policy
- (iii) Understand the impact of fiscal policy on different economic agents
- (iv) Understand the impact of fiscal policy on different economic activities

### **3.0 Main Content**

#### **3.1 Public Expenditure and the working of the Fiscal Policy**

Historically, the prominence of fiscal policy as a policy tool has waxed and diminished. Before 1930, an approach of limited government, or *laissez-faire*, prevailed. With the stock market crash and the Great Depression, policymakers pushed for governments to play a more proactive role. When policymakers seek to influence the economy, they have two main tools at their disposal—monetary policy and fiscal policy. Central banks indirectly target activity by influencing the money supply through adjustments to interest rates, bank reserve requirements, and the sale of government securities and foreign exchange; governments influence the economy by changing the level and types of taxes, the extent and composition of spending, and the degree and form of borrowing. Governments directly and indirectly influence the way resources are used in the economy. The basic equation of national income accounting helps show how this happens:

$$\text{GDP} = \text{C} + \text{I} + \text{G} + \text{NX}.$$

On the left side is gross domestic product (GDP)—the value of all final goods and services produced in the economy. On the right side are the sources of aggregate spending or demand—private consumption (C), private investment (I), purchases of goods and services by the government (G), and exports minus imports (net exports, NX). This equation makes it evident that governments affect economic activity (GDP), controlling G directly and influencing C, I, and NX indirectly, through changes in taxes, transfers, and spending. Fiscal policy that increases aggregate demand directly through an increase in government

spending is called expansionary policy. By contrast, fiscal policy is considered contractionary or “tight” if it reduces demand via lower spending. Besides providing goods and services, fiscal policy objectives vary. In the short term, governments may focus on macroeconomic stabilization—for example, stimulating an ailing economy, combating rising inflation, or helping reduce external vulnerabilities. In the longer term, the aim may be to foster sustainable growth or reduce poverty with actions on the supply side to improve infrastructure or education. Although these objectives are broadly shared across countries, their relative importance differs depending on country circumstances. In the short term, priorities may reflect the business cycle or response to a natural disaster—in the longer term, the drivers can be development levels, demographics, or resource endowments. The desire to reduce poverty might lead a low-income country to tilt spending toward primary health care, whereas in an advanced economy, pension reforms might target looming long-term costs related to an aging population. In an oil-producing country like Nigeria, fiscal policy might aim to moderate procyclical spending—moderating both bursts when oil prices rise and painful cuts when they drop.

In a period of economic crisis, which may have a negative impact on economy of a country, with financial sector difficulties and flagging confidence hitting private consumption, investment, and international trade (recall the national income accounting equation). Governments may respond by boosting economic activity through two channels:

- (i) automatic stabilizers and
- (ii) fiscal stimulus

That is, new discretionary spending or tax cuts. Stabilizers go into effect as tax revenues and expenditure levels change and do not depend on specific actions but operate in relation to the business cycle. For instance, as output slows or falls, the amount of taxes collected declines because taxpayers’ incomes fall. Unemployment benefits and other social spending are also designed to rise during a downturn. These cyclical changes make fiscal policy automatically expansionary during downturns and contractionary during upturns. Automatic stabilizers are linked to the size of the government, and tend to be larger in advanced economies. Where stabilizers are larger, there may be less need for stimulus— tax cuts, subsidies, or public works programs—since both approaches help to soften the effects of a downturn. In addition, although discretionary measures can be tailored to stabilization needs, automatic stabilizers are not subject to implementation lags (for example, design, approval, and implementation of new road

projects), and their impacts are automatically withdrawn as conditions improve. Stimulus may be difficult to design and implement effectively and difficult to reverse when conditions pick up. In many low-income and emerging market countries, however, institutional limitations and narrow tax bases mean stabilizers are relatively weak. Even in countries with larger stabilizers, there may be a pressing need to compensate for the loss of economic activity and compelling reasons to target the government's crisis response to those most directly in need. In countries with high inflation or external current account deficits, fiscal stimulus is likely to be ineffective, and even undesirable.

The size, timing, composition, and duration of stimulus also matter. Policymakers generally aim to tailor the size of stimulus measures to their estimates of the size of the output (expenditure) gap—the difference between expected output and what output would be if the economy were functioning at full capacity. A measure of the effectiveness of the stimulus—or, more precisely, its translation in terms of output (also known as the multiplier)—is also needed. Multipliers tend to be larger if there is less leakage (for example, only a small part of the stimulus is saved or spent on imports), monetary conditions are accommodative (interest rates do not rise as a consequence of the fiscal expansion), and the country's fiscal position after the stimulus is viewed as sustainable. Multipliers can be small or even negative if the expansion raises concerns about future sustainability, in which case the private sector would likely counteract government intervention by increasing savings or even moving money offshore, rather than investing or consuming. Multipliers also tend to be higher for spending measures than for tax cuts or transfers and for larger countries (in both cases, because of fewer leakages).

### **SELF ASSESSMENT EXERCISE**

Discuss the two main channels of fiscal policy through government use to boost economic activity.

### **3.2 Expenditure Policy**

The role of expenditure policy in economic development has been explored less extensively than that of tax policy. Low-income countries direct a higher share of expenditures to education and health services and a lower share to transfers. The higher share for education reflects the higher cost of educational services in these countries, the higher share of transfers in high-income countries reflects the more developed social security systems. The strategic role of public investment in economic development is based on the undeveloped state of private capital markets and on local scarcity of entrepreneurial talent. It is also based on the fact that the type of investment needed at the earliest stages of development includes large expenditures, such as those involved in the development of transportation systems or the opening up of undeveloped parts of the country. Moreover, infrastructure investment of this sort carries external benefits which require public provision.

Therefore, the development of public investment performs a major function in the design of development plans in low-income countries (LDCs). In this Context, the use of cost-benefit analysis is of great importance. Developing Countries cannot afford to waste scarce resources, and yet efficient project evaluation is a difficult task. In one respect, cost-benefit analysis is more readily applied in developing than in developed countries. This is because public investment is typically aimed at the provision of intermediate goods, the value of which may be measured in terms of their effects upon the prices of privately provided goods. Thus, the return on transportation or irrigation projects may be appraised in terms of the reduction in the cost of goods as they reach the market. This is a measure which cannot be applied where public outlays are used to provide final goods of the consumption type.

The direct benefits made available will be accompanied by indirect or external benefits which are harder to assess. For another, costs are more difficult to determine. Since market prices may not reflect the true social costs involved, shadow prices must be used in their place. If capital is undervalued while labour is

overvalued, the use of market prices leads to the previously noted distortion toward excessively capital-intensive technology. Further difficulties arise in the context of dynamic development where relative prices which apply when the project is introduced may give way to a quite different set of prices applicable during the years when the services of the project are rendered. This possibility points to the importance of long-run planning and the evaluation of individual projects in the context of an overall development plan.

Another factor of obvious importance is proper determination of the discount rate. With private capital markets not fully developed, use of a "social rate" may be more or less inevitable. Considerations suggesting the presence of external benefits indicate that the social rate should be set below the level of rates prevailing in the market, thus pointing to a higher rate of capital formation and the choice of long-term projects. Pointing in the other direction is the fact that the cost of forgoing current consumption is very high at low levels of income; yet, in the future when the gain from postponement is realized, the marginal utility of consumption will be less since income is higher. This fact tends to be overlooked in individual savings decisions but should be allowed for by government. But here, as in other matters of discount rate determination, crude approaches are likely to be used in the typical development context, the government may be confronted with the practical necessity of determining the politically acceptable minimum path of consumption and may derive the discount rate there from.

Human investment, as noted before, deserves particular consideration in the development context. Education programs are important not only as a matter of growth policy but also for their important bearing on how the gains from growth will be distributed both among income groups and among various sectors of the economy. Studies have shown exceedingly high rates of return on educational investment in developing countries, thus pointing to the particular importance of this form of capital formation, but it is essential that the educational inputs be designed to meet the country's need for specific labour skills.

### **SELF ASSESSMENT EXERCISE**

Discuss the important criteria to be considered in determining expenditure policy in Nigeria.

### **3.3 Effects of Public Expenditure**

The traditional economists held the view that the state should least interfere in economic activities and the government is merely an agent for the people to keep political organization intact. During the time of Adam Smith, the government that interfered least in the economic activities of the state was considered the best government. Till the beginning of the 20th century, state performed only limited functions—the maintenance of law and order and protection of the country from the external attack. Therefore, the state had to collect only small revenue and spend little. There has been a phenomenal increase in the magnitude and the variety of governmental activities in almost all countries of the world. The acceptance of the principle of welfare state, the necessity of maintaining full employment and economic development has increased the significant role of the government. All these show the need for an ever-increasing public expenditure. The following few paragraphs explain the important effects of public expenditure.

#### **3.3.1 Effects of Public Expenditure on Production**

Just as taxation, other things being equal, should reduce production as little as possible so the public expenditure should increase it as much as possible. The effects of public expenditure on production can be evaluated by examining its effects on the following:

- a) Effects upon ability to work, save and invest: Public expenditure may tend to influence the ability of the people to work, save and invest. This is described as 'efficiency effect'. Public expenditure designed to increase the efficiency of the people will certainly improve their ability to work. When a

person's ability to work is increased, his earnings will also increase. As a consequence, his ability to save also improves. For example, expenditure on education, health services, and cheap housing facilities, subsidized food, free education means of transportation, communication etc. will increase the efficiency of the people to work. Similarly, public expenditure incurred for maintaining law and order build up the confidence in the minds of the people which will in turn encourages them to invest in production activities. Public expenditure may have adverse effects also. If public expenditure is spent on wasteful social functions or on the production of intoxicants and drugs which are detrimental to health, the ability to work, save and invest of the people may adversely be affected. Hence, public expenditure should be incurred in such a way that it is most beneficial to entire society.

- b) Effects upon willingness to work, save and invest: Public expenditure may tend to affect the willingness of the people to work, save and invest which is described as 'incentive effect'. As far as the will to, save and invest is concerned, it depends to a great extent on the character of public expenditure and public policy of the governments. For example, old age pension, provident fund benefit, insurance against sickness and unemployment allowances etc., have an adverse effect on the willingness of the people to work, save and invest. This is because people will have a feeling that the government will look after them, when they are unable to earn an income. If, however, the benefit increases with the increase in work and the volume of savings, the willingness to work, save and invest will increase and vice-versa. Similarly, the willingness to work can be increased by making the benefits conditional, i.e., the people may be required to contribute something in order to avail the benefits of social security measures. Therefore, public expenditure should be incurred in a planned manner in order to provide social security measures to the maximum extent. Public expenditure should also provide opportunities under which savings and investments are properly rewarded and do not enlarge inequalities.
- c) Effects upon diversion of economic resources as between different uses and localities: Public expenditure can significantly influence the level and pattern of production through the diversion of economic resources between different uses and areas. For example, the public expenditure on projects like roads, railways, irrigation energy etc. helps in accelerating the tempo of economic development. Creation of such essential projects through diversion of economic resources from private use to public use is very essential in developing countries. Similarly, concessions and subsidies by governments may help many industries and agricultural activities. According to Dalton the role of public expenditure in the diversion of economic resources from private use to government use and among different regions is important only when the area of economic activities of the government is limited i.e. in a capitalistic economy. The forms of public expenditure which increase the productive power and are socially very much desirable for the transfer of resources are generally of the following nature.
  - (i) Debt redemption
  - (ii) Developmental projects like irrigation, power and transport, roads, railways etc.
  - (iii) Promotion of education, research, inventions training etc.
  - (iv) Provision of public health and
  - (v) Social security etc.

Public expenditure also results in the diversion of resources among different regions. This will reduce the regional inequality. In order to bring about regional balanced growth, the government has to provide special expenditure programmes to economically backward regions. Such diversion of resources among regions is made possible by setting up a federal system of government. Grants-in-aid from central government to state governments and from state governments to local governments are examples of

diversion of resources. In short, the public expenditure does have many favourable effects on production.

### **3.3.2 Effects of Public Expenditure on Distribution**

One of the important modern state policies, especially in developing countries and socialist countries, is reduction of inequalities in the distribution of income and wealth. Public expenditure plays vital role in realizing this objective. The system of public expenditure which has the strongest tendency to reduce inequality of income is the best. Public expenditure which is in the form of money grants, supply of social goods and services, social security measures, subsidies etc. certainly affects the distribution of income in a country in socially desirable way. Expenditures carried out for benefiting the poor people such as those on social services like free medical treatment, free education, unemployment benefit etc. will enhance the benefit of the poor section than the rich. This will help in reducing the inequality between the rich and the poor in the distribution of income and wealth, thus bringing about justice in the economy.

### **3.3.3 Public Expenditure and Stability**

Economic stability refers to a fairly stable level of national income, employment, prices, savings and investments in the economy. The economy may face cyclical fluctuations on account of imperfections in the market (depression and inflation). Public expenditure can be used to check the fluctuations. According to Keynes (1936), economic instability implies departure from full employment at stable price level. It is the deficiency of the effective demand caused by a low marginal propensity to consume coupled with low marginal efficiency of investment. During depression the effective demand falls short of what is required. Deficiency in effective demand leads to unemployment which in turn reduces consumption and fall in production. To solve the situation public expenditure can be enhanced to compensate the deficiency in effective demand. The increased public expenditure during the time of depression is described as compensatory public expenditure. In a period of depression, the suitable public expenditure policy will be deficit budgeting. (i.e. current expenditure should be in excess of current revenue). Similarly, during the time of inflation, government has to adopt surplus budgeting policy. During inflation that part of the public expenditure which reduces the funds going to the people with higher propensity to consume is reduces. After full employment, public expenditure is likely to add to inflationary pressure because it will further increase the purchasing power of the people without corresponding increase in production.

## **4.0 Conclusion**

From the discussion here, we have been able to:

- Explain public expenditure and the working of fiscal policy
- Explain expenditure policy
- Explain the effects of public expenditure on economic actors and economic activities.

## **5.0 Summary**

This unit explain the working of fiscal policy and public expenditure and various expenditure policy. It also discusses the effects of public expenditure on the economy. It shows that fiscal policy in less developed countries differs in important respects from that in developed countries and this variation is due to the fact that the economic and social setting in LDCs is different.

## **6.0 Tutor-Marked Assignment**

Submit a two-page essay on the effects of expenditure policy on economic activities and economic actors.

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<b>Module Four</b>	<b>Economics of Public Debt</b>
Unit 1	Introduction to Public Debt Economics
Unit 2	Public Debt and Budget
Unit 3	Debt Burden and Intergeneration Equity

## **Unit 1 Introduction to Public Debt Economics**

### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 Meaning and Composition of Public Debt
  - 3.2 Objection to Government Borrowing
  - 3.3 Issues in Public Debt and Debt Management
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
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### **1.0 INTRODUCTION**

The revenue side of the government budget does not always balance the expenditure side. There could be budget surplus in terms of expenditure been less than revenue. Under this situation, government can save and build-up reserve. There can also be budget deficit in which revenue less than expenditure. In this case the government has to rely on past saving to finance the budget deficit (government deficit).

When budget deficit is persistent, it's referred to as fiscal disease. In other words, borrowing money may be triggered by inability to accumulate reserves. There are some circumstances, even in the best of years when in very unlikely circumstances, a country experienced a balanced budget, and government may still find it necessary to borrow. This is because of the difference in timing between the flow of government revenue and the flow of government expenditure. Recurrent expenditure is incurred almost on a continual basis. Beyond these two points, government can also engage in borrowing because of the characteristics of the economy. You may find an economy where national income fluctuates over time, government tries to accumulate surplus in good years so as to save some resources from which they can draw in bad years. This module discusses the causes of government debt and composition of government debt. It also discusses the effects of public debt on the economy.

## **2.0 OBJECTIVES**

At the end of this unit, students should be able to:

- (i) Understand the meaning and composition of public debt
- (ii) Understand reasons behind objections to government borrowing
- (iii) Understand issues in public debt and public debt management

## **3.0 MAIN CONTENT**

### **3.1 MEANING AND COMPOSITION OF PUBLIC DEBT**

Public debt arises out of borrowing by the government specifically the treasury from the banking system, financial institutions such as pension funds, insurance company, business organizations, households and individuals. The debt is usually in form of formal documents or instruments expressing the binding promise of treasury to pay the holder of such note a stated principal sum and the interest specified on the principal. The ability to lend money to the government is influenced by the following factors:

- (i) The amount of integrity and trustworthiness of the government
- (ii) National or jurisdictional wealth of productive resources
- (iii) Tax revenue capacity of government in relation to expenditure commitment
- (iv) The confidence of the people in government

Therefore, the reasons for borrowing can be summarized as follows:

- (i) Government borrows for emergency such as war and depression.
- (ii) Government also borrows to finance capital projects such as roads, electricity.
- (iii) To finance capital assets for self-liquidating public enterprises - such public enterprises produce certain goods which are in the form of private goods needed by some groups of people in the society.
- (iv) To finance current expenditure in anticipation of an increase in revenue by the end of the year.

#### **3.1.1 COMPOSITION OF PUBLIC DEBT**

Public debt can be internal and external. It is internal when the government sells her security to its citizens within her domestic economy and external when the same security is sold to the citizen and other bodies outside the domestic economy. The duration of debt instruments is both short term and long term.

The short-term duration is usually less than 5 years and long term is more than 5 years. The various means by which government secures loans for her projects are:

- (i) Treasury Bills: These are used to meet short-term obligations and usually only last for 91 days

- (ii) Treasury Certificate: This is a medium term borrowing because it takes relatively longer period usually one or two years and commands higher rates of interest than treasury bill.
- (iii) Development Stocks: This is a source of raising revenue to finance government expenditure. There are usually issued for a long period of year (5 years). This attract specific interest depending on the date of maturity.

### **SELF ASSESSMENT EXERCISE**

Define public debt and discuss various forms of government borrowing.

### **3.2 OBJECTION TO GOVERNMENT BORROWING**

Several objections have been raised against government borrowing. Some of these arguments include:

- (i) Debts include increased cost due to interest charges
- (ii) Borrowing tends to be less anti-inflationary than taxation. Debt will reduce private spending less than taxation. This is because taxation affects the purchasing power of every economic agent whereas debt affects those who lend to government.
- (iii) In borrowing, people may suffer from what is called debt illusion. This is because of the ease at which the money is obtained. In other words, government are less careful about attaining efficiency in spending borrow that they are at spending money raised from taxation.
- (iv) It can have income and substitution effects on the recipient government. If government borrow freely, large tax obligations can be built up for future tax payers who may not have benefited from the government spending. In other words, debt has created burden for future generation and it worse if people have not benefited from government spending. It creates intergenerational equity.

### **SELF ASSESSMENT EXERCISE**

Discuss the main reasons for objections to government borrowing.

### **3.3 ISSUES IN PUBLIC DEBT AND DEBT MANAGEMENT**

In addition to the choice of maturities, a number of issues in debt and debt management are as follows:

#### **(i) Interest Ceiling**

The story of the interest ceiling reflects the historical controversy between tight and easy money. It has been a recurrent theme in many country monetary and political history. Whatever view of the issue of interest ceiling, it should not be resolved by a rigid ceiling. The appropriate mix of fiscal, monetary, and debt policies should be determined on its merits and in line with current policy objectives, with bond yields and refunding patterns adjusted to this policy mix. The interest ceiling places an undesirable constraint on the conduct of stabilization policy which may necessitates its removal.

#### **(ii) Inflation**

Public debt usually leads to inflation. One proposal, advanced repeatedly over the years is for the issuance of a "stable purchasing power bond." The redemption value of such a bond would vary with the cost-of-living index, thus protecting small investors against the loss of purchasing power from inflation as well as depriving them of a (less likely) gain if prices should fall. The coupon rate on such a bond would be correspondingly lower, since it would carry no inflation premium. Its availability would be of great value to small investors who find it difficult to protect themselves against inflation.

#### **(iii) Refunding**

Increase in the federal debt requires debt managers to decide what debt to issue, but this is only a minor part of debt management. The major problem is to expedite the refunding of maturing issues. Refunding operations have traditionally involved highly complicated procedures, requiring precise

estimation of yields demanded by the market. New issues are now sold through an auction system in many country, with closed bids received from the dealers and then met on a first-come, first-served basis. Increased reliance on short term debt, sold at discount rather than with a coupon, has facilitated this development.

**(iv) Agency Debt and Government Lending**

Government also involved in the debt of federal and federally sponsored credit agencies. This type of debt has expanded substantially in recent years in many countries. In providing for the use of these funds, government lending (as distinct from spending) enters the scene as an additional instrument of budgetary policy. Lending, like debt retirement, reduces the net debt position of the government. In a perfect capital market, extension of a ₦50,000 loan with a ten-year maturity would be equivalent to retirement of a ₦50,000 debt issue of similar maturity, assuming the same tax revenue to be used to finance either transaction. But the results of the two transactions may be quite different in an imperfect market. The recipient of the government loan might not have been able to obtain credit elsewhere. Indeed, a major rationale of government lending is to provide funds to creditors who have not been able to obtain them otherwise but who, for reasons of public policy, should be provided with funds. It is thus typically used as an instrument of allocation rather than as stabilization policy, and as such, is particularly important in the context of developing countries where government-supported investment is an important feature of development policy.

**(v) The Market for State and Local Debt**

The problem of debt management for state and local governments is altogether different from that at the federal level and more like that of private investors attempting to secure funds in the market. The difference holds for both the demand and the supply sides of the picture. On the demand side, the occasion for borrowing by state and local governments occurs primarily when substantial capital expenditures are to be financed. It is prudent that such outlays be loan-financed rather than tax-financed. The rationale for borrowing at the state and local level is thus quite different from that at the federal level where stabilization policy is the primary determinant. On the supply side of the market for funds, a state or local government, unlike the federal government, has no control over the money market conditions under which it must borrow. The best it can do is to obtain funds on a favourable terms as happen to be open to it: and the cost of borrowing differs widely, depending on the fiscal position of the jurisdiction and its credit rating. The cost at which funds are available to various borrowing jurisdictions enters as an important factor into the provision of those state and local services which involve heavy capital outlays, e.g., highways and school buildings. Such outlays are important from the national as well as the state and local perspective, so that state and local borrowing enters as an additional aspect of fiscal federalism.

**(vi) Tax Exemption versus Direct Interest Subsidy**

Federal policy gives general support to state and local borrowing by excluding interest on such securities from taxable income under the federal income tax. An investor whose marginal tax rate is 50 percent will be willing (other things being equal) to substitute a public bond yielding 4 percent for a corporate bond yielding 8 percent. Taxpayers whose marginal tax rate exceeds 33 percent will thus have an inducement to hold state and local issues. This tax advantage thus diverts funds into the tax-exempt market, thereby reducing the cost at which state and local governments can borrow.

But this particular form of aid is subject to criticism on two grounds. First, it interferes with the equity of the income tax structure. High-income recipients who receive tax-exempt interest pay less tax than do others with equal income from other sources. Moreover, the value of tax exemption rises with bracket rates so that vertical equity is interfered with. On these grounds alone, it would be preferable to provide such assistance as is desired in a way which does not involve tax preferences. The

second objection is that tax exemption results in a smaller gain in terms of interest savings to state and local governments than would be provided by a direct subsidy involving the same cost to the federal government. The reason is that the effective rate of subsidy for state and local governments equals the marginal tax rate of the lowest-bracket buyer for whom the incentive is effective. This is a further reason why a direct subsidy would be preferable to the interest exemption.

#### **(vii) Intergenerational Shifting of the Debt Burden**

According to the capital stock theory by David Ricardo and later on developed by A.C. Pigou, public investment projects can be financed either through tax revenue or through borrowed capital. Whether this shift the burden to future generation depend upon the extent of real capital inherited by it. The welfare of future generation depends upon the sacrifice of present consumption without which capital cannot be pooled to build up large productive base. However, the curtailment of current consumption depends on the reaction of present generation to the withdrawal of real resources from the private economy, for the creation of public investment projects.

If the investment project is financed by borrowed funds, which are through floating public debt, the bond holders are likely to curtail investment than consumption. The purchasers of bond will pay for them more out of saving than out of consumption. This is because; they consider their net wealth position better under loan finance than under tax finance. If projects are financed by taxation, taxpayers are more likely to curtail consumption, because their disposable income is reduced. But under situation of loan finance, the bond holders can easily monetize their debt, by selling them at any time in the money market. Hence, they are as liquid as money. Hence the bond holders never feel that lending has reduced their disposable income. Hence, they feel that they have become richer. Even though loan finance carries with it the obligation of future generation to pay interest and repayment of debt, nobody is sure about the exact amount he has to pay in future. Due to these reasons, the bond holders never subscribe public debt by way of reduced consumption to finance investment projects. Rather they pay for debt out of the saving which can otherwise be spending on other type of investments. As a result, the reduced level of saving causes less 'real productive capital' to be inherited by future generations. Thus, a real burden in the form of 'reduced output potential' is passed along through this "indirect" means to future generations.

The most appropriate answer to the debt burden controversy was provided by Richard. A. Musgrave. He argues that debt finance for public investment projects necessarily spreads the burden among different generations, whereas tax finance causes the present generation to bear the burden. The Musgrave's approach is based upon the 'benefit principle' of equity in debt burden distribution. He is of the opinion that the cost of public investment projects should be borne by the users in proportion to the benefit they enjoyed.

#### **SELF ASSESSMENT EXERCISE**

Discuss the main issues surrounding public debt and its management.

#### **4.0 Conclusion**

From our discussion on public debt, we have been able to identified that:

- the meaning and composition of public debt
- Criticism against public debt.
- Issues in public management.

#### **5.0 Summary**

This unit has simply introduced us to the meaning of public debt and composition of public debt. It further discusses the criticisms against public debt. Also, issues surrounding public debt and public debt management were also discussed. All these are expected to have provided a good foundation for the subject matter of this module.

### **6.0 Tutor-Marked Assignment**

Submit a two-page write up on intergenerational transfer of debt burden.

### **7.0 REFERENCES /FURTHER READINGS**

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## **Unit 2**

## **Public Debt and Budget**

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2.0 Objectives

3.0 Main Content

3.1 Public Debt

3.2 Budget

4.0 Conclusion

5.0 Summary

6.0 Tutor-Marked Assignment

7.0 References/Further Reading

### **1.0 INTRODUCTION**

Among the non-tax sources, the major source of revenue of the government is public debt. That is, borrowing. Borrowing can either be internal or external. This unit further expound on public debt and government budget. It discusses the causes of public debt and classification of public debt. It also discusses budget in details. This is to further provides explanation on public debt and government budget.

## **2.0 OBJECTIVES**

At the end of this unit, students should be able to:

- (i) Understand the important sources of public debt
- (ii) Understand methods of debt repayment
- (iii) Understand the components and types of budget
- (iv) Understand fiscal deficit and the consequences of fiscal deficit

## **3.0 MAIN CONTENT**

### **3.1 PUBLIC DEBT**

Public debt is a non-tax source of government revenue. Borrowing may either be internal or external debts depending on whether it is sourced locally or from other countries of the world or international lending organizations. When the government raises revenue by borrowing within the country, it is called internal debt. Similarly, if the government borrows from the rest of the world, it is a case of external debt. According to Philip E. Taylor, “The debt is the form of promises by the treasury to pay to the holders of these promises a principal sum and in most instances interest on the principal. Borrowing is resorted to provide funds for financing a current deficit.”

Till the beginning of the 20th century, state performed very limited functions such as maintenance of law and order, protection of the country from external attack etc. Therefore, the state had to collect only small revenue and little debt. In contemporary society, in almost all countries of the world there has been a great increase in the degree and variety of governmental activities. The acceptance of the principle of the welfare state increases the role of state participation in economic activity. This has necessitated the need to find out additional sources of finance. Hence, modern governments rely on public borrowings. The objectives of public debt include:

- (i) To bridge the budget deficit (deficit Financing)
- (ii) To protect against depression.
- (iii) To check inflation.
- (iv) To finance economic development.
- (v) To meet unforeseen contingencies.
- (vi) An alternate source of income when taxable capacity is reached.
- (vii) To finance wars.
- (viii) To finance public enterprises.
- (ix) To carry out welfare programmes.
- (x) To create infrastructure.
- (xi) For creation of productive assets.
- (xii) For creation of essential non-income yielding assets (provision of public goods) etc.

#### **3.1.1 Sources of Public Debt**

Every government has two major sources of borrowing—internal and external. Internally the government can borrow from individuals, financial institutions, commercial banks and from the central bank. Externally, the governments borrow from individuals and banks, international institutions like IMF, IBRD, ADB etc. and from foreign governments. They can be summarized as follows.

- (i) Borrowing from individuals.
- (ii) Borrowing from Non-Banking Financial Institutions (Insurance companies, investment trusts, mutual funds etc.)
- (iii) Borrowing from commercial banks.
- (iv) Borrowing from central banks.
- (v) Borrowing from External sources (IMF, IBRD, ADB, Foreign Governments or countries)

### **3.1.2 Classification of Public Debt**

Public debt can be classified as follows:

- (i) Voluntary and Compulsory (on the basis of legal enhancement): Voluntary debt is the debt which is paid any legal enforcement. Whereas compulsory debt is legally forced in nature. Here people have no option but repay the debt.
- (ii) Funded and unfunded debt (provision for repayment): Funded debt is long term or 'definite period' debt. A proper agreement and terms and conditions of repayment with the percentage of interest payable are declared. They are used for creation of permanent assets. Unfunded debt is for a short term and for indefinite period. It is paid through the income received from other sources. These are used for meeting current needs.
- (iii) Internal and external debt: When the government raises revenue by borrowing from within the country, it is call internal debt. Whereas if the government is borrowing from the rest of the world, it is case of external debt.
- (iv) Productive and Unproductive (purpose of loans): Loans on Projects yielding income (construction of plants, railways, power schemes etc.) are called productive debt. Loans on non-income yielding projects are called unproductive loans (war, famine relief etc.)
- (v) Redeemable and Irredeemable loans (promise to repay): Redeemable debts refers to the loan which the government promises to pay off at some future date (principal plus interest). Irredeemable debts are those principal amounts of which are never returned by the government but pays interest regularly.
- (vi) Short / Medium/ Long term loans (Time duration): Short term loans are usually incurred for a period varying from three months to one year. Usually governments get such loans from the central bank by using treasury bills. These loans are calls 'ways and means advances.' Medium Term loans are those which are obtain for more than one year but less than ten years. Long term loans are those which are obtain for more than ten years and financing developmental activities.

### **3.1.3 REDEMPTION OF PUBLIC DEBT**

Redemption of public debt means repayment of a loan and it is an important responsibility of the government. All government loans should be repaid promptly. It is, therefore, necessary that the provision of repayment should be inherent in the scheme itself. Advantages of debt redemption include:

- (i) It saves the government from going into bankruptcy.
- (ii) It checks extravagance on the part of the governments.
- (iii) It preserves the confidence of the lenders.
- (iv) It makes easy for the government to float future loans.
- (v) It reduces the cost of management of public debt.
- (vi) It saves the future generations from the pressure of public debt.
- (vii) The resources obtained after redemption of the debt would be diverted towards private investments and therefore a favourable climate for investment could be created.
- (viii) Redemption of debt may act as a useful tool to curb deflation.

### **3.1.4 METHODS OF REPAYMENT OF DEBT**

- (i) Repudiation: It means refusal to pay a debt by governments. This method was followed by the USA after the civil war and by the USSR after the 1917 Revolution. This method is undesirable and has not been used recently anywhere in the world. Repudiation shakes the confidence of the people in public debt and many provoke retaliation from creditor countries.

- (ii) **Refunding:** Refunding is the process of replacing maturing securities with new securities. In some cases, the bonds may be redeemed before the maturing date when the government intends to rearrange the maturity of outstanding debts or when current rate of interest is low. Generally, short-term borrowings are made in anticipation of tax collections for meeting current expenditure. However, excessive burden of new expenditure does not permit the retirement of the debt by means of revenue newly raised or by means of long term borrowing. Thus, there is necessity of refunding the loans by old lenders and renewing the loans at lower rate of interest for future period. The drawback of this method is that government is tempted to postpone its obligation of debt redemption. This leads to a continuous increase in the burden of public debt in future.
- (iii) **Conversion of Loans:** It is a special type of refunding. Conversion of existing securities into new one before maturity. It is generally used to reduce the burden of debt by converting high interest loans into low interest loans. The conversion of loan does not reduce the burden of public debt on the state; because a reduction in interest rates reduces the ability of the creditors to pay taxes which may mean a loss of income to the governments thereby reducing its capacity to repay loans.
- (iv) **Sinking Fund:** Sinking fund is a special fund created for the repayment of public debt. There is a theoretical justification for creating this fund because it imposes a requirement on the government to pay the old debts regularly. According to this method, the government sets aside a certain amount out of the budget every year for this fund. The balances in the funds are also invested and the interest accruing on them is also credited in the fund. Sinking fund is of two types: (i) Certain sinking fund—here, the governments credit a fixed sum of money annually. (ii)Uncertain sinking fund— the amount is credited when government secures a surplus in the budget. The disadvantage of this method is that the government may not wait till the end of the period of maturity and utilize the fund for some other purpose than the one for which the fund was created originally. The practice of sinking fund inspires confidence among the lenders and the enhancement of the creditworthiness of governments.
- (v) **Capital levy:** Capital levy is a special type of “once for all” tax on capital imposed to repay war debts. All capital goods are taxed above a minimum level of assets possessed by residents of the country. Simply, capital levy refers to a very heavy tax on property and wealth. This tax was levied immediately after the First World War. This method has been advocated by economists like David Ricardo, Pigou and Dalton. Capital levy as a method of debt redemption put least real burden on the society. It is useful due to its deflationary character.
- (vi) **Surplus budget:** Surplus budget may be used to clear public debt. But due to the ever-increasing public expenditure, surplus budget is a rare phenomenon.
- (vii) **Buying up of Loans:** Governments redeems debt through buying up loans from the market.

### **SELF ASSESSMENT EXERCISE**

Discuss various means of debt redemption.

### **3.2 BUDGET**

The term budget was derived from a French word ‘bougette’ which means a leather bag or purse. The term ‘budget’ is commonly understood as a document presented by a government containing an estimate of proposed expenditure for a given period and proposed means of financing them for the approval of

legislation. According to the constitution of most countries, government has to present in the parliament an annual financial statement showing estimates of revenue and expenditure. This is called the annual financial statement or budget. Hence, government budget is a schedule of all revenues and expenditures that the government expects to receive and plan to spend during the following year. A budget includes:

- a) financial actions of the previous year
- b) budget and revised estimates of the current year and
- c) the budget estimates for the following year.

For example, in the budget 2013-14 there will be the actual estimates of 2011-12, the budget estimates and revised estimates for the year 2012-13 and the budget estimates for the year 2013-14. The budget is presented in the parliament by the President. Similarly, the State Governments also present the budget in the State Legislatures in countries with federal system of government.

### **3.2.1 FEATURES OF BUDGET**

- a) It is a statement of expected revenue and proposed expenditure.
- b) It is sanctioned by some authority.
- c) It is periodicity, generally annual and
- d) It prescribes the manner in which revenue is collected and expenditure is incurred.
- e) Budget is prepared on cash basis.
- f) Rule of lapse- All unutilized funds within the year 'lapse' at the end of the financial year.
- g) Realistic Estimation.
- h) Estimates to be on Departmental Basis.

### **3.2.2 OBJECTIVES OF A BUDGET**

Budget is an important tool of financial administration and an effective means of enforcing fiscal policies. The main objectives of a budget are: (i) Re-allocation of resources (ii) Re-distribution of resources (iii) Stabilization of resources (iv) Sources of information to the public of the past, present and future activities and plans and programmes of the relevant governments (v) Tool of government policy (vi) Estimate of income and expenditure (vii) An instrument of fiscal policy (viii) Basis of public welfare (ix) To ensure financial and legal accountability.

### **3.2.3 COMPONENTS OF A BUDGET**

The government budget is divided into revenue and capital budgets. Revenue budget is related to current financial transactions of the government which are of recurring nature. Revenue Budget consists of the revenue receipts of the government and the expenditure met from these revenues. Revenue account deals with taxes, duties, fees, fines and penalties, revenue from government estates, receipts from government commercial concerns and other miscellaneous items, and the expenditure therefrom. Revenue receipts include receipts from taxation, profits of enterprise, other non-tax receipts like administrative revenue, gifts, grants etc. Revenue expenditure includes interest-payments, defense expenditure, major subsidies, pensions etc. Capital budget is a statement of estimated capital receipts and payments of the government over fiscal year. It consists of capital receipts and capital expenditure. The capital account deals with expenditure usually met from borrowed funds with the object of increasing concrete assets or of reducing recurring liabilities such as construction of buildings, irrigation projects etc. Capital Receipts include borrowings, recovery of loans and advances, disinvestments and small savings. Capital expenditure includes developmental outlay, non-developmental outlay, loans and advances and discharge of debts.

### **3.2.4 TYPES OF BUDGETS**

Based on the balancing of revenue and expenditure, budgets are divided into balanced budget and unbalanced Budget.

**Balanced Budget:** A balanced budget is that over a period of time in which revenue does not fall short of expenditure. i.e. revenue is equal to expenditure (Revenue= Expenditure).

### **Unbalanced Budget**

The Budget imbalance may be due to an excess of expenditure over income or an excess of income over expenditure. In other words, budget may either be surplus or deficit. A budget is said to be surplus when public revenue exceeds public outlay ( $R > E$ .) A deficit budget means a budget when expenditure exceeds revenue ( $R < E$ .) There are different types of deficits depending on the types of receipts and expenditure. The important types of deficits are:

- (i) **Budgetary deficit:** The budgetary deficit shows the gap between total receipts and total expenditures of the government. The budgetary gap is financed by issuing 91-days treasury bills and running down on the government's cash balances with treasuries and central bank. Budgetary deficit is equal total revenue minus total expenditure.
- (ii) **Revenue deficit:** Revenue deficit is the excess of revenue expenditure over revenue receipts. Revenue Deficit= Revenue Receipts-Revenue Expenditure.
- (iii) **Fiscal Deficit:** Fiscal Deficit is the excess of total budget expenditures over the total budget revenue excluding borrowings. In other words, fiscal deficit is budgetary deficit plus borrowings and other liabilities. The gross fiscal deficit is the excess of total expenditure over revenue receipts and non-debt capital receipts. That is Fiscal Deficit = Total expenditure - (revenue receipts + non-debt capital receipts). Net Fiscal Deficit = Gross Fiscal Deficit - Net loans and advances. The significance of fiscal deficit is that it is a measure of total borrowing requirements of the government. It shows the extent of dependence of the government on borrowings to meet its budget expenditure. The consequences of fiscal deficit are as follows:
  - a) **Accumulation of Public Debt:** It encourages non-plan, non-productive and inflationary public expenditure.
  - b) **Increase in the burden of interest payments:** There is enormous rise in the cost of servicing the public debt. The whole expenditure constitutes non-plan, non-productive and non-developmental expenditure.
  - c) **Generation of inflationary pressure:** Accumulated fiscal deficits over years have been responsible for growing non-plan expenditure and add to inflationary pressure.
  - d) **Adverse effect on Developmental expenditure:** Besides the rising defense expenditure and civil expenditure on ministries and their employment, the increased interest payments due to the past borrowings is a major cause of growing non-plan, non-developmental government expenditure which takes a large size of total expenditure, restricting the scope to raise the developmental expenditure especially on capital formation. In short, the fiscal deficit shows how far the exchequer is running beyond its means. The larger the fiscal deficit, the larger the borrowings will be.
- (iv) **Monetized Deficit:** It refers to the sum of the net increase in holdings of treasury bills of the central bank and its contributions to the market borrowings of the government. It creates equivalent increase in high powered money or reserve money in the economy. In other words, it denotes government borrowing from the central bank.

### **SELF ASSESSMENT EXERCISE**

Discuss the components and types of budget.

#### **4.0 Conclusion**

This unit has further exposed us to:

- Debts and its implications on the economy
- Budgets, composition of budget and types of budget
- The impacts of budget on the economy and individuals
- The relationship between debts and budget

#### **5.0 Summary**

This unit further discuss debts and budget with implications of both on the economy. It provides details discussion on classification of debts and types of budget and the linkages between debts and budgets. This further deepen our knowledge about debts and its impacts on the economy.

#### **6.0 Tutor-Marked Assignment**

Give a details account of the process of budget preparation in Nigeria.

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### **Unit 3**

### **DEBT BURDEN AND INTERGENERATION EQUITY**

#### **CONTENTS**

- 1.0 Introduction
- 2.0 Objectives
- 3.0 Main Content
  - 3.1 Public Debt and Fiscal Solvency
  - 3.2 Burden Transfer with Outside Debt
  - 3.3 Burden Transfer with Generation Overlap
  - 3.4 Justification for Burden Transfer
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

## **1.0 INTRODUCTION**

We now consider a different aspect of the debt problem, namely, the proposition that debt finance burdens future generations. If so, this is both a critique of borrowing (since it may be abused by burdening future generations with the cost of services which are enjoyed currently) and an argument for borrowing (since it may be used to secure intergeneration equity by passing on the cost of capital outlays to the future).

## **2.0 OBJECTIVES**

At the end of this unit, students should be able to:

- (i) Understand the burden of debt
- (ii) Understand intergenerational transfer of burden of debt
- (iii) Understand means of transferring burden of debt

## **4 MAIN CONTENT**

### **3.1 PUBLIC DEBT AND FISCAL SOLVENCY**

The debate over debt burden was between those who feared that the creation of debt in the course of deficit finance would burden the future, and others who, in defending such finance, argued that it would not do so. More specifically, the argument advanced by the opponents of deficit finance was that the burden of all public expenditures falls on the taxpayer, with loan finance merely delaying the tax payments to the time when the debt will be paid off. The burden is thus postponed and future generations are born with the obligation to pay off the debt. One may argue that this submission was wrong and that there is no need to pay off debt, since it becomes part of the country's claim structure and may be refunded at maturity rather than paid off. Hence, only interest payments create additional tax requirements.

The opposing argument was that such interest payments would impose no burden on future generations since (assuming the debt to be held domestically) the future generation would contain both taxpayers' and interest recipients. Gains and losses would therefore wash out, leaving no problem of net burden; there would merely be a transfer from one party to another. Domestic debt imposes no burden since "we owe it to ourselves. One may view this argument as being correct in that interest payments involve no loss of resources to the group as a whole, but it overlooked the frictional effects of taxation. As argued before, taxation may impose an excess burden and cause deadweight losses. The severity of such effects is likely to rise with the overall level of taxation or ratio of tax revenue to GNP. As the debt-GNP ratio rises, the ratio of tax revenue (needed to service the debt) to GNP also rises. Conceivably, it becomes so large as to pose a serious tax-disincentive problem, a factor which is overlooked in the "we owe it to ourselves" proposition. Debt accumulation during wars may be so drastic as to lead to fiscal breakdown and debt repudiation in the postwar period.

However, so long as the debt does not grow at a higher percentage rate than GNP, the debt-GNP ratio does not rise and there is little reason why it should rise at a faster rate. Although the finance of World War II resulted in a sharp increase in the ratio of debt to GNP, the subsequent growth of the economy reduced the ratio by 1970 to below its pre-war level. Rising interest rates since then again raised the interest-GNP ratio to close to the 1946 level.

#### **3.3.1 BURDEN TRANSFER THROUGH REDUCED CAPITAL FORMATION**

An important aspect of the burden problem focuses not on the debt itself but on the effects of loan and tax finance upon growth and the capital endowment passed on to future generations. Once more we return to the framework of a "classical" system where investment adjusts itself to the level of saving at a

full-employment level of income. Given such a system, a  $\$1$  of both tax and loan finance reduces private expenditures by  $\$1$ , but tax finance is more likely to fall on private consumption, whereas loan finance will tend to fall on investment. For any given set of public expenditures, substitution of loan for tax finance therefore reduces the growth rate of the economy. Future generations will be left with a smaller endowment and hence will receive a lower income. It is this reduction in endowment or net worth which is the vehicle of burden transfer.

This mechanism of burden transfer operates even though the resource withdrawal from private use occur at the very time the public expenditure is made. In this narrower sense, the immediate cost must be borne by the generation that releases these resources. Yet, it makes a difference whether the resource withdrawal is from consumption or from capital formation. In the first case, generation 1, which finances the expenditure, assumes the burden by reducing its private consumption. In the second case, it makes no such sacrifice but reduces the future income and potential consumption of generation 2. Burden transfer, therefore, occurs whenever generation 1, in transferring funds to the government, responds by reducing its capital formation in the private sector."

Therefore, the conclusion that loan finance results in burden transfer whereas tax finance does not reflect the assumption that the former tends to fall on capital formation while the latter does not. This assumption is in the right direction. Although, as we have seen earlier, the distinction may be overdrawn. Moreover, the government's ability to choose between loan and tax finance to allocate burdens between generations depends on the assumption that this financing mix does not affect aggregate demand. Under more realistic assumptions, as noted in the discussion of stabilization policy, tax finance is likely to be more deflationary, i.e., to result in a sharper reduction in private expenditures. In such a system, the combination of tax and loan finance must be set to secure the desired level of aggregate demand. Therefore, it cannot also be set to secure an allocation of private resources between consumption and investment in line with considerations of intergeneration

### **SELF ASSESSMENT EXERCISE**

Discuss the arguments of the two opposing camps about the intergenerational transfer of debt burden.

### **3.2 BURDEN TRANSFER WITH OUTSIDE DEBT**

Having considered the role of domestic borrowing, we now turn to that of borrowing from outside sources. The mechanism of burden transfer through foreign borrowing differs in several respects. A first difference is that there is no need for generation 1 to reduce its expenditures. Consumption and capital formation in the private sector can remain intact as the additional resources needed for the public outlay are acquired abroad. Loan finance now imposes a burden on generation 2 not by leaving it with a reduced capital endowment at home but by saddling it with an obligation to service the foreign debt. Taxes will now be paid to finance interest paid to foreigners rather than to domestic holders of the debt. Generation 2 will no longer owes the debt to itself. This foreign debt burden replaces the loss of capital income which generation 2 would have suffered had there been domestic loan finance and a resulting reduction in capital formation.

Compare now our three sources of finance - taxation, domestic borrowing, and foreign borrowing. Assuming taxation falls on consumption and domestic borrowing on capital formation, then

- a. debt will burden the present generation while domestic borrowing and foreign borrowing will burden the future.
- b. While domestic borrowing and foreign borrowing are similar in this respect, the choice between them may not be a matter of indifference. The answer depends upon the cost of borrowing at

home and abroad. If the cost is the same (if the return on domestic capital is the same as the outside rate of interest), the burden on generation 2 will be the same in each case. But if the domestic return is higher, foreign borrowing will be preferable, and vice versa if the domestic return is lower.

### **SELF ASSESSMENT EXERCISE**

Describe how debt burden is determined to fall on present generation or future generation.

### **3.3 BURDEN TRANSFER WITH GENERATION OVERLAP**

When considering the problem of burden transfer between generations whose life spans do not overlap, we discovered that reduced private capital formation is the only mechanism (other than foreign borrowing) by which a burden transfer to the future can occur. But this is not a necessary condition if the two generations overlap in time. Suppose that generation 1 lives from year 1 to year 50, while generation 2 lives from years 25 to 75. Also suppose that all taxes come from consumption. Now generation 1, in year 1 may be called upon to pay taxes of ₦200,000 to sustain the cost of a government building with a useful life of 50 years and will do so at the cost of reducing its own consumption by this amount. But it will then be possible, in years 25 to 50, to collect taxes of ₦100,000 from generation 2 in order to refund generation 1, thus involving a shift in private consumption from generation 2 to generation 1.

In this way generation 1, while initially assuming the entire burden, can transfer part of it to generation 2. For purposes of reassurance generation 1 may be given a promise of repayment in the form of bonds, to be redeemed later out of taxes imposed on generation 2. Such a transfer among overlapping generations can function even though there is no effect on capital formation in the private sector. As a variant to this case, generation 1 may make a present to generation 2 and assume the entire burden without calling upon generation 2 for repayment later on. This is precisely the mechanism which applied when old-age retirement pensions were introduced and the aged were given benefits without having had to contribute.

#### **3.3.1 BORROWING BY STATE AND LOCAL GOVERNMENTS**

The problem of intergeneration equity arises most acutely at the state and local levels where the bulk of public investment expenditures are made and financed. Suppose a township is to construct a school building, the services of which will extend over thirty years. The expenditures thereon call for a sharp, once-and-for-all increase in the total outlays of the township. If this construction were to be tax-financed, a temporary increase in the tax rate would be needed. This may be undesirable, since taxpayers find it easier to live with a more or less stable tax rate. Moreover, and more important it would be unfair to place the entire burden on those who pay taxes in this particular year. Since the use of the facility will extend over thirty years, it is fair to spread the burden among the successive "generations" which will benefit from the service. The principle of benefit taxation is applied in allocating the burden between generations.

To accomplish this, the initial cost is covered by borrowing outside markets. In subsequent years, future generations, partaking of the benefits, are taxed each year in accordance with their current benefit share. In the process, the debt is amortized and repaid by the time the facility is used up. Once more, intergeneration equity is secured with each generation paying for its own benefit share. A township which finances its school building by borrowing and amortizing the debt over the length of the asset life thus provides for an equitable pattern of burden distribution between age groups and between changing groups of residents as the population of the jurisdiction changes in response to in-migration and out-migration.

### **3.3.2 BURDEN TRANSFER IN DEVELOPMENT FINANCE**

The preceding discussion has an unhappy application to the problems of development finance and economic growth. The mechanism of burden transfer, while it may be used to spread the cost of public investment, cannot be used to spread the cost of a development program. The problem does not arise if one considers a steady stream of annual investment with a constant population. Current tax finance will then match the current flow of benefits. Such at least is the case if we disregard both the position of the first generation which is discriminated against and that of the doomsday generation which will benefit. The reason is that the very objective of such a program requires that total capital formation (public or private) be increased. But no gain is made toward achieving this objective if public capital formation is loan-financed, where this causes an offsetting decline in the rate of private capital formation. Unfortunately, the mechanism of burden transfer through internal loan finance is unsuitable in a situation where it would be most appropriate. However, this does not hold with regard to foreign borrowing.

#### **SELF ASSESSMENT EXERCISE**

How does the burden of State and local government debts transfer to the future generation?

### **3.4 JUSTIFICATION FOR BURDEN TRANSFER**

Similar to the differential view of tax incidence, the problem of burden transfer was to see how the future generation would be affected by alternative methods of finance for a given expenditure project. When the matter of justification for burden transfer is considered, the expenditure side or the principle that public services should be financed on a benefit basis, each generation should pay for its own share in the benefits received must be brought into the picture. Applying this principle to public capital outlays, the benefits of which will extend into the future, it follows that loan finance and burden transfers are called for as a matter of intergeneration equity. Assuming that tax finance falls on consumption while loan finance falls on capital formation, tax finance of current and loan finance of capital outlays is in line with intergeneration equity. Loan finance of current expenditures places an undue burden on the future and tax finance of capital outlays gives it an undue benefit. This is the rationale for the use of a capital budget especially at the level of local finance and for the use of foreign borrowing in the case of development finance. It may also be interpreted to justify heavy reliance on loan finance to sustain the cost of war.

#### **SELF ASSESSMENT EXERCISE**

Provide a brief justification for the transfer of debt burden.

### **4.0 Conclusion**

From our discussion of debt burden and intergeneration equity, we have observed that:

- Debt management is concerned mainly with refunding the large volume of debt which matures annually. In examining this problem, the following conclusions were drawn:
- The relationship of the public debt to the solvency of government does not depend on the absolute level of debt but on its level relative to that of GNP.
- The public debt becomes part of the economy's claim structure and need not be paid off at maturity. The problem, rather, is one of debt service, including refunding and the finance of interest payments. These costs however, depend upon the ratio of interest payments to GNP.
- In the absence of generation overlap, a burden transfer to the future generation take the form of reduced capital formation.
- In the Context of the classical model, loan finance may be expected to fall more largely on investment, whereas tax finance may be expected to fall more heavily on consumption. Loan finance may thus be a means of transferring a burden to the future generation.

- Foreign borrowing permits financing of public programs without placing a burden on the present generation and it is particularly important in the context of development finance.
- Another mechanism of burden transfer may be applied in a situation where the present and- future generations overlap.
- Burden transfer is in line with intergeneration equity where the public outlay will result in future benefits.

## 5.0 SUMMARY

This unit discuss the transfer of debt burden to the future generation and different ways of doing that. It also discusses the burden of State and local governments debt of present and future generations. And finally, provide discussion of debt burden in development finance and justification for transfer of the debt burden.

## 6.0 Tutor-Marked Assignment

Provide a two-page discussion on debt burden and intergenerational equity.

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## Module Five

## Fiscal Federalism

Unit 1	Inter Governmental Fiscal Relations
Unit 2	Fiscal Federalism in Nigeria
Unit 3	Development Finance

## Unit 1 INTER GOVERNMENTAL FISCAL RELATIONS

### CONTENTS

- 1.0 Introduction
- 2.0 Objectives

- 3.0 Main Content
  - 3.1 Equalization of Fiscal Position
  - 3.2 Benefit Spillovers
  - 3.3 Equity Advantages of Central Taxes
- 4.0 Conclusion
- 5.0 Summary
- 6.0 Tutor-Marked Assignment
- 7.0 References/Further Reading

## **1.0 INTRODUCTION**

We have earlier discussed the design of an efficient fiscal structure in which the stabilization and distribution functions belong to the central government and the allocation function is performed by jurisdictions defined as benefit areas which may be local, regional or national in scope. In such a normative system each jurisdiction would carry out and finance (from taxes paid within its borders) its appropriate allocative functions without reference to the fiscal activities of others. Anyone resident would be within the boundaries of various jurisdictions and contribute to their respective activities. This module examines intergovernmental fiscal relations and fiscal federalism in Nigeria. This provides insight into how different levels of government relate in taxation and expenditure policy and how the expenditure policy of lower levels of government are coordinated in a federal system of government.

## **2.0 OBJECTIVES**

At the end of this unit, students should:

- (i) Understand fiscal relations of different levels of government
- (ii) Understand equalization of fiscal position
- (iii) Understand reasons for coordinating adjustments by the central government

## **3.0 MAIN CONTENT**

### **3.1 EQUALIZATION OF FISCAL POSITION**

Intergovernmental fiscal relations i.e. fiscal transactions and coordinating arrangements among the various levels of government and communities exist for various reasons among which are:

- (i) Intervention by a higher level of government may be needed to correct for spillover of benefits.
- (ii) The government may consider local public services as merit goods and wish to subsidize them.
- (iii) The philosophy of fiscal federalism may call for some degree of equalization in the fiscal position of lower-level jurisdictions.
- (iv) Fiscal differentials among jurisdictions may result in inefficiencies in location which need to be moderated.
- (v) Advantages of central government taxation may lead central government revenue to be substituted for lower-level revenue

It has been already shown that the use of fiscal policy for stabilization purposes has to be at the central level. Lower levels of government cannot successfully carry on stabilization policy on their own for a number of reasons. Therefore, spending and taxing measures by lower level, of government whether in an expansion, or restrictive direction would be nullified by trade leakages. These leakages do not arise or are smaller if fiscal measures are undertaken at the national level. Stabilizing fiscal policy requires periodic budgetary deficits or surpluses with corresponding borrowing and debt repayment. These pose a more serious problem for local governments which have less ready access to the national capital markets and no control over supporting monetary policy should it be needed. The implications of local government debt are different from those associated with national debt. Local debt is held by creditors

outside the jurisdiction and the use of debt finance at the local level should be secured to secure an equitable burden distribution among generations. Whereas decentralized fiscal policy for stabilization purposes is largely ruled out by the foregoing considerations, the use of monetary policy by lower levels of government is even less acceptable. Central banking policy is a national function, not only would decentralized monetary policy be seriously blunted in its effectiveness by the openness of the regional economy but the power to print money would invite monetary irresponsibility at the state or local level.

In sum, the necessary degree of fiscal coordination is not likely to emerge in a decentralized setting, so central responsibility for stabilization action is required. This is not to say, that central government responsibility for stabilization policy need not account for the needs of state and local governments. Thus, levels of spending and taxing at the lower levels of government may be influenced by the central governments stabilization policy. Just as full employment of resources must be the concern of stabilizing measures at the central level, so must economic growth be implemented by central government policies.

Beside spillovers, the central government may wish to influence the fiscal behaviour of lower-level governments in order to raise the level of local public services. To put it differently the central government may view local public services as merit goods. This concern may be directed at local expenditures in general or at selective categories only and financial support may be given to raise public services without limit or it may be restricted assure minimum levels.

The desire of central government to give support to local public services may be combined with objectives of fiscal equalization. Some jurisdictions-states or local-enjoy a high taxable capacity (the tax rate needed to obtain a given level of revenue is low) and have a relatively low level of need (the amount required to provide certain service levels is small). They are thus in a fiscal strong position, as measured by the ratio of capacity to need. Others are the reverse position. The central government may then wish to equalize fiscal positions and it may do so in the following ways:

- (i) The central government wish to equalize actual service levels for this purpose impose such matching grants (where needed to raise level) or taxes (where needed to lower levels) as are required to secure full equalization.
- (ii) The central government may wish to secure common minimum levels and adjust its grant policy to secure this objective.
- (iii)The central government may wish to equalize the cost-in terms of the effort or tax rate required-of providing public services in various jurisdiction. While leaving into the local jurisdiction to decide what service level it wishes provide. This approach referred to as "power equalization." calls for matching grants to jurisdictions which are fiscally weak i.e. which have a high taxable capacity and large needs; and these grants would be financed by taxes on the expenditures of strong jurisdictions. i.e. which have a high taxable capacities and low needs.

As distinct from equalizing cost in terms of tax effort, the central government may wish to eliminate differences in service level which result from differences in income or wealth. As noted before, these policies do not aim at correcting the distribution of income or general wellbeing among individuals but rather at equalizing the terms at which local social goods are provided. This implies a view of distribution in line with categorical equality, as well as a recognition of local public services as merit goods.

### **SELF ASSESSMENT EXERCISE**

Discuss the main reasons for intergovernmental fiscal relations.

### **3.2 BENEFIT SPILLOVERS**

One major reason for coordinating adjustments among jurisdictions is that existing jurisdictions do not correspond to benefit and tax cost areas. Spillovers result and may be due to a number of factors as follows:

- (i) The first cause arises from the complexities of benefit areas. Since spatial patterns differ for various types of public services the model would call for different but overlapping jurisdictions for each service. A person residing in anyone location would be a member of various "service clubs." For some services the individual would join with close neighbours only, while for others the neighbourhood concept would be extended to involve some distance. This system would be exceedingly complex especially where benefits are not uniform within a region but where extensive spatial "tapering off" of benefits occurs. The administrative and political costs speak for a more consolidated and simplified system with governmental units performing a variety of functions and departing considerably from the principle of equivalence between taxing and benefit areas.
- (ii) Another source of non-equivalence may arise because people and business are mobile. As a result, public expenditure benefits in one jurisdiction may be earned over to another. For example, benefits from education expenditures embodied in the form of "human capital" get transferred to other jurisdictions with the out-migration of the educated. Other benefits (such as police and fire protection) may be currently consumed by sub-urban residents who commute to the city but have no part in deciding on and paying for the services in question.
- (iii) Finally, and most important existing Jurisdictions are historically given. They were not created on the basis of fiscal rationality alone. State or city boundaries do not neatly coincide with benefit limits and once established, they are not readily adjusted for purely fiscal reasons. For all these reasons benefit and cost spillovers from one jurisdiction to another occur.

Spillovers must be accounted for and internalized if public service levels are to be efficiently determined. Unless the non-resident recipients of the benefit spillover, pay compensation to the community from which they emanate, there will be an undersupply of the public good in question. In some cases, it may be practicable to redraw boundaries or reassign spending responsibilities. Thus, in recent years there has been a trend in countries toward the creation of special government agency to carry out certain functions the benefits of which extend across local and state boundaries. Examples are water-pollution abatement programmes, sanitation districts and metropolitan transit systems. In most, instances intergovernmental cooperation will be needed while in some cases direct negotiation between jurisdictions may be feasible.

The problem is similar in principle to the previous discussion of benefit externalities from personal consumption. In particular, it resembles the small-number case of that discussion. If jurisdictions a provides for service X, it may yield not only benefits in consumption for the residents of A but also spillover benefits which are consumed by the residents of Jurisdiction B. The latter are not accounted for by A, but should be internalized to yield efficient provision. This may be achieved through bargaining, as jurisdiction B may benefit by paying A for increasing its level of provision and by substituting this for B's own provision. Thus, negotiation tends to lead to some degree of internalization but there is no assurance that an efficient solution will be reached.

### **3.2.1 FISCAL DIFFERENTIALS AND DISTORTIONS IN LOCATION**

A case for fiscal coordination arises where fiscal advantages or disadvantages of particular jurisdictions distort location decisions. A particular taxpayer, whether a corporation or an individual, may find jurisdiction A preferable to jurisdiction B because A's tax structure will result in a lower tax bill and/or because the structure of public services is more beneficial. Such differentials affect both product and factor flow and thereby interfere with efficient production.

The purpose now is not just to equalize the tax costs which an individual face in various jurisdiction. What matters is the net differential or fiscal residue, whether it is the excess of benefit, over costs or that of costs over benefits. The need for coordination is of particular importance at the international level where fiscal differentials are large; but, to a limited degree, they also arise within a single country like Nigeria.

### **SELF ASSESSMENT EXERCISE**

Briefly discuss the factors responsible for spillovers in intergovernmental fiscal relations.

### **3.3 EQUITY ADVANTAGES OF CENTRAL TAXES**

Central taxes have the advantage of avoiding distortions in location, but they may also be preferred on grounds of equality. By drawing on the entire economy, the tax base can be defined more comprehensively, as can be done especially with the corporation profits tax. Moreover, progressive taxation cannot be applied effectively by lower-level jurisdictions. This leaves the function of progressive taxation largely at the federal level. Since the burden distribution of the overall tax system is the weighted average of taxes applicable at the federal, state, and local levels, overall progressivity depends upon their respective shares in total revenue. In the absence of grants, these in turn are determined by the respective levels of expenditures at each level of government.

By the use of grants from the federal to the state and local levels, in making grants for this purpose, the federal government would share its revenue (presumably revenue from the income tax) with the state at which the revenue originated. At the same time, this transfer of the taxing function to the higher level would interfere with the requirement that each jurisdiction should determine and pay for these services whose benefits are limited to. If all taxes in all jurisdictions were imposed on a benefit basis such differentials would not exist and fiscal factors would not distort location decision. More precisely, this situation would exist only if "benefit taxation" were interpreted to call for setting taxes equal to total rather than marginal benefits. Since location choices are all-of-nothing propositions, it is the total benefit that matters. Jurisdiction is one of the dilemmas which have to be faced in order to reconcile the advantages of fiscal decentralization with the disadvantages of resulting distortions in location decisions.

### **SELF ASSESSMENT EXERCISE**

Briefly discuss equity advantages of federal taxes.

## **4.0 Conclusion**

From our discussion of intergovernmental fiscal relations, we have been able to identified:

- the reasons for equalization of fiscal position
- Benefit spillovers of intergovernmental fiscal relation
- Fiscal differentials and distortions in location
- Equity advantages of central taxes

## **5.0 Summary**

This unit discuss the reasons for intergovernmental fiscal relations, the principle of benefit externalities, fiscal differentials and distortions in location and equity advantages of central taxes. This is to further provide insight into the workings of taxation and fiscal policy. It's also provide foundation for the discussion of fiscal federalism in the next unit.

## **6.0 Tutor-Marked Assignment**

In not more than three pages, discuss intergovernmental fiscal relations.

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## **Unit 2                      Fiscal Federalism in Nigeria**

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- 3.0 Main Content
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## **1.0 INTRODUCTION**

Federation may be defined as a form of political association in which two or more states constitute a political unity with a common government but in which the member states retain a measure of internal autonomy. The decentralized fiscal system, or fiscal federalism have received much attention in the public finance literature. This has due in part to an extension of the theory of social goods, initially conceived in terms of national governments, to the problem of state and local governments. It has also reflected certain developments in the many countries fiscal structure, including an imbalance in the distribution of resources and needs among jurisdictions, which have called for a reconsideration of the fiscal roles to be performed by various levels of government and of their relations to one another. This unit explore the theoretical aspects of fiscal federalism with an insight into the Nigerian situation.

## **2.0 OBJECTIVES**

At the end of this unit, students should:

- (i) Understand the theoretical underpinnings of fiscal federalism
- (ii) Understand principles of federal finance
- (iii) Understand consequences of fiscal fragmentation
- (iv) Understand factors that guide fiscal federalism in Nigeria

## **3.0 MAIN CONTENT**

### **3.1 PRINCIPLES OF FISCAL FEDERALISM**

Fiscal federalism is also referred to as fiscal decentralization and multi-level finance. It occurs when different layer of government is exerting influence on the same individual particularly as relating to government expenditure and revenue. Several countries are practicing multilevel finance which include Nigeria, South-Africa, Germany, France, Brazil, Ethiopia, Canada, USA etc. In a federation there is a division of legislative, executive and financial powers between the centre and state governments. The duty of the federal government is to fulfill its responsibilities towards the states while utilizing its own financial powers within its own jurisdiction. To preserve federal principles, B.P.A Darker lays down three principles for the smooth functioning of a federation. These principles of determining the financial policy in a federal set up are as follows:

- (i) **Principle of Independence and Responsibility:** The first principle for the efficient and smooth functioning of the federal financial system is that each government should have independent financial resources and should be responsible for raising resources for meeting its obligations. Financial independence and responsibility are two fundamental requisites for the success of fiscal federalism. According to A. Darker, " full freedom of financial operations must be extended to both Federal as well as State Governments so that they do not suffer from a feeling of cramp in the discharge of their normal activities and in the achievement of their legitimate aspirations for the promotion of social and economic advancement." In other words, national and

sub-national governments should be financially independent within their own sphere. Besides, each government should take the responsibilities of taxing, borrowing and raising resources in their spheres for performing their functions. The authority which has the pleasing job of spending money should also do the unpleasant job of taxing it. Thus, “taxing autonomy and spending autonomy go hand in hand”. However, financial independence is difficult to practice because of the problem like uniformity in tax rates throughout the federation, promotion of economic growth, maintenance of internal and external stability, balancing social and economic development in all regions etc. The cardinal principle to be followed in a financial settlement is that the federal government and the states should be endowed with independent sources of revenue free from mutual interference and the balancing factors should come in only marginally to fill the gaps.

- (ii) Principle of Adequacy and Elasticity: The principle of adequacy means that the resources of the federal government and local governments should be adequate for each level of government to discharge its obligations. Principle of elasticity means that there must be feasibility to expand resources in response to its needs especially during the period of internal and external crisis.
- (iii) Administrative Economy and Efficiency: The administrative cost of finances should be at minimum and there should be no tax evasion. Administrative efficiency can be achieved, if the resources are allocated properly between the centre and the state governments.

Other principles that can be identified include:

- a) Principle of Uniformity and Equity: Principle of Uniformity means that there should not be any discrimination among different units in a federation, while distributing resources among various states. Thus, the contribution of each state in federal taxes should be according to ability or economic considerations. Similarly, in order to achieve equity in taxation, a proper balance between direct and indirect taxes should be maintained. Therefore, there should be a proper adjustment between federal and state taxation to make the tax burden on all the citizens equitable.
- b) Principle of Accountability: Freedom and democracy are interwoven in a federal system. Therefore, the government in a federation should be accountable to its own legislature for its spending and collecting revenue decisions.
- c) Principle of Fiscal Access: This implies that there should not be bar on federal and state governments in tapping new sources of revenue within their own prescribed areas to meet the growing financial needs. That is, resources should grow with the expansion of responsibilities.
- d) Principle of Transfer of Resources: This means that there should be provisions for transferring the resources from one state to the other. The ideal allocation of resources between federation and states should be in accordance with the principle of national minimum which can be achieved through the transfer of resources from rich countries to poor regions in a federal set-up.
- e) Principle of Federal Supervision: There should be supervision by the federal government to ensure whether state governments follow the rules and regulations with regard to taxation and expenditure laid down by it from time to time.
- f) Principle of Integration and Co-ordination: According to this principle, the whole financial system of a federation should be well-integrated and coordinated. Integration of financial

systems of federal government and state governments is essential in contemporary federations. Similarly, coordination is essential for smooth and efficient functioning of federal financial system.

- g) **Social Principle of Federal Finance:** The social principle of an effective system of federal finance is fiscal equity. Fiscal equity requires that individuals in similar economic circumstances should receive equal net fiscal benefits where they reside in the nation. For achieving fiscal equity in a federal country there are two ways. Firstly, through introduction of equalizing transfers that provide additional revenue to areas with relatively low revenue capacities and / or relatively high expenditure needs, and secondly, through the imposition of basic minimum national standards with respect to certain public goods.

### **3.1.1 TYPES OF FISCAL IMBALANCES**

There are two types of fiscal imbalances in a federal nation. These are vertical fiscal Imbalance and horizontal fiscal Imbalance.

- (i) **Vertical Fiscal Imbalance:** The important characteristic of federation is the co-existence of two main levels of governments having the capacity to raise revenues and responsibility to carry out various functions. Vertical balance is an ideal situation in a federation. That is, a matching of expenditure responsibilities and taxing powers, enabling each level of government to be financially sufficient. The imbalance in this regard is termed vertical fiscal imbalance. That is, vertical fiscal imbalance refers to the difference between expenditures and revenues at different levels of governments. This arises when one level of government financial resources exceeds its needs, whilst the other lacks sufficient resources to carry out its functions. This is a common feature of all multi-level governments. A common solution to this type of imbalance is a scheme of intergovernmental grants as a corollary to the allocation of taxing powers.
- (ii) **Horizontal Fiscal Imbalance:** Horizontal fiscal imbalance is referred to as the existence of economic inequalities among the states such that, if they were all to have equal standards to public expenditure from their own revenue sources, some of them would have to set their taxes and other charges at a higher overall level than others. This state of affair can be described as inequalities of fiscal capacity. In other words, horizontal fiscal imbalance refers to the mismatch between revenues and expenditures of governmental units within a level of governments. Such an imbalance is related to horizontal economic imbalance. It refers to inter-state economic disparities resulting from differences in area, climate, topography, soil and mineral resources, factor endowments etc. That is why, horizontal fiscal imbalances are not exogenous to the states fiscal management and do not provide a rationale for intergovernmental transfers.

### **SELF ASSESSMENT EXERCISE**

Discuss the principles of fiscal federalism

### **3.2 MERITS AND CONSEQUENCES OF FISCAL FEDERALISM**

The merits of fiscal federalism are as follows:

- (i) It meets society preference with respects to the allocation of public goods. That is, it permits allocation of resources that merits people preferences.
- (ii) It allows for effective collective decision making. With decentralization the number of person involved are smaller. Although the knowledge of costs and benefits may be greater but there is more direct relationship between the benefits to be received and the real costs of providing the

services. Indeed, it has been argued that with fiscal decentralization greater population control can be exercised over the precise manner in which the services are provided.

- (iii) It facilitates experimentation and innovative creation on the part of the federating units. Various units will try different approaches to problems and the successful techniques will be adopted by other units. They will be pressure on the various local units to match the efficiency of comparable units. In this sense, the danger of diseconomies of scale are avoided.
- (iv) Optimal allocation of functions: Two factors are relevant in the allocation of functions among the different layers of government vis:
  - a) Geographical Range of Spillover Effects (externality): In general, optimal allocation functions among the different levels of government require that government should provide goods and services that benefit the entire people within the country. And that those activities that can be divided geographically should be made available by the local and state government. There are no doubt groups of people benefitting from particular activities cannot be delineated into mutually exclusive groups. As a result, the sub-national governments cannot be completely autonomous in their expenditure and revenue decision.
  - b) Economies of Scale in Production: The concern here is that certain goods and services could be provided in large quantities than others. In other words, the cost of production declines as output increases. While many services such as police, fire protection and educational services can be provided with full attainment of economies of scale at the local government level other goods and services may require larger units than those optimal on the basis of homogeneity of preferences.

However, four consequences of fiscal fragmentation can be identified as follows:

- (i) Attainment of Optimal Tax Structure: This became extremely difficult when there is fiscal fragmentation because each government determine the policy she wants the tax to take independently. For optimal tax structure to be attained there must be simultaneous tax adjustment by all levels of government. In practice, simultaneous adjustment is impossible because some units will act first while others will consider such actions before taken their decision.
- (ii) Reduction in Tax Capacity: Fragmentation of tax structure reduce the total tax capacity of the lower levels of government compare to the ability of unified government to finance the same level of activity. This is predicated on the nation that the larger the tax jurisdiction relative to the country as a whole, the more effectively government can operate a tax both administratively and economic wise. Some type of tax cannot be administered by relatively small jurisdiction because they do not have access to information to access the tax payer or the lower level of government may not have the legal means to enforce tax payment. Local units are fearful of tax competition because of the implication on the movement of capital and labour. Given the level of taxation of other state, a particular state will be reluctant to raise its taxes above the level existing in other states for fear of loss of business and population. There is also fear of tax competition (i.e. about effect or voting by feet). Because of reduction in tax capacity the level of service provided by state and local government may be below desired level and secondly, some states or local units may disproportionately tie reliance on the use of tax that are least affected by inter-state competition.
- (iii) Unequal Fiscal Capacity: The point here is that when the fiscal system is fragmented there will be unequal strength in the revenue due to unequal population. There may be some state with high

population and low income and some with low population, highly industrialized and may have high per capita income (PCI). The implication is that such services will be carried farther by the rich states relative to the poor states. The poor states are to maintain the same level of providing the same services and impose higher tax which can lead to relocation of business and labour.

- (iv) Another problem is the problem of administrative and Compliance: Duplication of activities may render administration and compliance complicated.

### **SELF ASSESSMENT EXERCISE**

Discuss the merits and demerits of fiscal federalism.

### **3.3 FISCAL FEDERALISM: THE NIGERIAN CASE**

Since 1900 Nigeria public finance has undergone structural changes. In 1906 the colony of Lagos was merged politically with the protectorate of southern Nigerian and became colony and protectorate of southern Nigeria. This was followed by artificial amalgamation of Northern and Southern Nigeria by Sir Lord Lugard in 1914. Before then, the two areas were administered separately. By implication issues related to public finance were treated separately. The striking effect before 1914 was that the south recorded persistent budgets surplus while the north recorded persistent budget deficit and the deficit was financed by imperial government. However, there is fiscal relationship between the North and South. About 7 percent of the revenue collected from custom duties at the ports in the south were paid to the north while the south retains the remaining 93 percent. It is often argued that the first twelve years witness limited centralization (1914 – 1926) with each unit doing their things separately. Thereafter (from 1926) there was complete centralization of Nigerian budget as no distinctions were made between north and south.

The protectorate of Southern Nigeria was divided into Western and Eastern region in 1939. From 1948 to independence in 1960 there was fiscal decentralization though limited. It was quite compatible with the practice between 1914 and 1926. There were also native authorities collecting tax, hence, there are Federal and native authorities collecting tax up to this time). Following the constitutional development in 1946, the issue of fiscal federalism became prominent. The Philipson fiscal commission was set-up because the Richard constitution provided some measures of fiscal responsibilities to regional government. Since each region was to now have her own budget, it was expedient to now make funds available to them so that they can discharge their expenditure responsibilities. The importance attached to this led to the appointment of Sir Philipson in June, 1946 to comprehensively examine the issue of revenue allocation scheme to be adopted. The Philipson fiscal commission eventually recommended three principles for allocating revenue vis derivation, population and even progress (balanced development). Each of these are discussed in turn below.

- (i) Derivation: Derivation principle says that each region should be allocated revenue according to its contribution to centrally collected revenue. That is each will receive according to its contribution. To this extent, derivation is compatible with the principle of equity and fairness in revenue allocation. An important reason why this commission recommended this is that they wanted to instill fiscal discipline in each region since the principle stresses the alignment of expenditure with revenue. It was also recommended in anticipation that regional government will increasingly gain fiscal autonomy over time. On both grounds, this principle of allocating revenue is legitimate and desirable. However, Philipson commission recognized that this principle could make the rich region richer and make the poor region poorer. But the merits of this principle outweigh the demerits. Before then, derivation principle applied to the revenue obtained from import and exercise duties on tobacco, import duties on motor fuel, salt and spirit,

export duties and mining rents and royalties. About 50% of tobacco import duties was based on consumption and export duties was based on production.

Derivation has been attacked for several reasons. It was argued that derivation principle cannot be fair because it will be difficult to determine precisely the actual amount of the goods consumed by each region, hence there is a problem of accurate statistics. At this time the country was on the early stage of development and did not possess the capacity to effectively carry out the calculation required. More fundamentally, the figures used were based on fraud estimates i.e. guess work and broad estimate approximation which could be subject to wide-margin of error. It was also attacked on the basis that it promotes regional antagonism, disunity, hostility a host of other unhealthy rivalry among the region. The antagonists exploited the point raised by the Philipson commission that the principle make the rich, richer and the poor, poorer and concluded that it promotes unbalanced development. However, there is counter argument that this is an unfounded argument, that there was unequal fiscal capacity therefore unbalanced development is inevitable. The issue of even development is ruled out in the presence of unequal fiscal capacity.

(ii) Population: In the 1970's two principles feature prominently. These are equality of states and population. Therefore, population was also used as a basis for revenue allocation. The basic logic behind population is that development of economy has to do with development of human capital and research. But the usage of population here is crude because it didn't take the demographic characteristic of the state into account. Some states have more children and youth hence their dependency ratio is high to other states with low dependency ratio. It has been difficult in Nigeria to achieve complete population census due to using population as a basis for revenue allocation.

(iii) Even Progress: Balanced development among region was also recommended as a one of the principle of revenue allocation in Nigeria. This is to ensure that some states were not left behind in the development process in the country.

Other principles like landmass (10%) has been used for revenue allocation under horizontal allocation. Vertical allocation has also been used for revenue allocation among different levels of government in Nigeria. The sharing formula for vertical allocation has changed overtime. The Federal Government (48.5%), State (24%), local government (20%) and Others (7.5%). At large, federal government has always control about 70% of the total revenue and that is what usually prompted the issue of high fiscal centralization. Hence when dealing with revenue allocation among various levels of government in Nigeria, you are dealing with vertical revenue allocation. This high fiscal centralization often brings about the intergovernmental fiscal conflict or tension.

### **SELF ASSESSMENT EXERCISE**

Discuss fiscal federalism in Nigeria.

### **4.0 Conclusion**

From our discussion of fiscal federalism, we have been able to identified that:

- the meaning, merits and consequences of fiscal federalism
- the principles of fiscal federalism
- the guiding criteria of revenue allocation in Nigeria.

### **5.0 Summary**

This unit tagged fiscal federalism in Nigeria introduced principle of fiscal federalism and the criteria of revenue allocation among the three tiers of government in Nigeria. It further discusses the Nigerian experience as per fiscal federalism and looked into the basic recommendation of the first revenue allocation commission in Nigeria. All these are expected to deepened our knowledge on fiscal federalism.

### **6.0 Tutor-Marked Assignment**

Submit a three-page write up on fiscal federalism in Nigeria.

### **7.0 REFERENCES /FURTHER READINGS**

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## **Unit 3                      Development Finance**

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  - 3.2 Fiscal Policy, Stability and Growth
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### **1.0 INTRODUCTION**

The requirements for economic development include those needed for continued and sustainable economic growth. To achieve this growth, not only are capital formation (including investment in both physical and human capital) and technological progress needed, but also certain changes are required in the social and institutional settings which have been both cause and effect of a low level of economic development. The public sector has an important part to play in all these ingredients of development. This unit is preoccupied with the discussion of the necessary requirements for economic development especially in developing countries like Nigeria.

### **2.0 Objectives**

At the end of this unit, students should:

- (i) Know the ingredients of development
- (ii) Understand the role of fiscal policy, stability and growth in development
- (iii) Understand the effects of tax structure policy on development
- (iv) Understand the effect of tax incentives and expenditure policy on development

### **3.0 MAIN CONTENT**

#### **3.1 INGREDIENTS OF DEVELOPMENT**

Public finances, on both the tax and expenditure sides of the budget, play a key role in the process of economic development. Many of the difficulties which obstruct the economic progress of low-income countries call for solution by the public sector; yet the institutional and social settings of such countries do not aid rapid economic development. Many of the problems associated much to development finance. However, development finance poses additional problems and others such as tax-structure appear in a somewhat different light. For this reason, the major ingredients of development are discussed in this section.

#### **3.1.1 CAPITAL FORMATION**

A fundamental requirement of economic development is an increased rate of capital formation relative

to that of population expansion. Such capital formation includes all expenditures of a productivity increasing nature. It may take the form of investment in the public or the private sector. Particularly in the early stages of development, the former is of critical importance since, in the form of so-called infrastructure (power, communications, port facilities. etc.), it sets the framework for subsequent manufacturing investment whether public (in the socialist economies) or private (in the mixed economy case). Furthermore, capital formation includes investment in human resources in the form of education and training as well as in physical assets. Indeed, where human productivity is adversely affected by malnutrition and disease, increased food consumption and provision of sanitation and health facilities take on the aspect of investment in human capital. Thus, the use of resources for productivity-enhancing purpose, may take a wide variety of forms, and the actual mix must be determined in the process of expenditure and resource planning.

There has to be a reduction in current consumption to release the necessary resources for investment purposes except unutilized resources are brought into use or additional resources are procured from abroad. To a certain extent, the mobilization of unused resources may be possible. It has been argued, for example, that many low-income economies possess substantial amounts of underutilized labour which may be put to work on simple forms of public capital formation, such as drainage, irrigation, roads, and dams. The government then acts only as organiser of this improved resource use. Another possibility is to obtain the needed investment resources from abroad in the form of official loans and grants or as private investment. Neither source, however, is likely to do the whole job, and in any case, will not be forthcoming without supportive effort on the part of the host country. Private investors from abroad, like private investors at home, require the necessary infrastructure investment; and official aid will most likely be conditional upon well-formulated development plans which include provision for substantial tax-financed increases in domestic investment.

Taxation has an important role to play in providing savings incentives and/or disincentives to luxury consumption. Business saving may also be encouraged through a system of business income taxation which encourages the retention and reinvestment of earnings. Voluntary private saving, while useful and important, cannot be expected to be sufficient in itself, particularly at an early stage of development. An economic climate conducive to private saving takes time to develop, and in the meantime, the less developed country must look to the government budget as the most promising source of finance for development purposes. Thus, public sector saving may be increased by raising total tax revenue and/or reducing current expenditures. Tax revenue must be looked on as a precious and scarce resource and many development plans have failed as a result of the profligate spending policies of the government which in turn was often acting under political pressure. Government savings generated by a surplus in the current budget may be used to finance capital formation in either the public or the private sector. In the latter case, the government savings may be channeled into private investment as debt or equity capital through the medium of government lending agencies or development banks.

### **3.1.2 TECHNOLOGY, ENTERPRISE, AND EFFICIENCY**

Improved technology is another important element in the development process, including manufacturing and agriculture. The massive improvements in agricultural productivity in a number of developing countries over the past decade attest to the benefits to be derived from improved technology in that sector. A principal benefit of private investment from abroad lies in the improved technologies which it brings, although it is important that these be adapted to the particular conditions and resource endowments of the less developed countries (LDCs). Tax provisions may be designed to stimulate and encourage the use of improved techniques. Business enterprise is needed if a flourishing private sector is to develop alongside the public sector. In its absence, government enterprise must fill the gap, as with technology, the tax structure can be designed so as to encourage the willingness to undertake productive investment

Efficiency in resource use is of critical importance in the resource-scarce LDCs. This factor involves proper expenditure evaluation on the part of the government as well as a development plan which avoids wasteful bottlenecks arising during the development process.

### **3.1.3 SOCIAL AND POLITICAL FACTORS**

Some of the most intractable problems associated with economic development include the whole range of social attitudes and organizations which have to be modified if development is to proceed, At the same time, a substantial degree of political stability is also needed to allow individual initiative to flourish, development plans to be implemented, and the necessary economic transformation to take place, It is therefore crucial that the fruits of development are broadly established and that extremes of income inequality prevalent in many of the LDCs be eliminated. While certain kinds of redistributors, (e.g., land reform) can be undertaken without prejudice to the level of output and indeed may be helpful in this respect, conflicts can arise between policies directed toward a more equitable distribution of income and the objective of increased saving and investment. Whereas public saving can be increased by raising the level of taxation, private incentives to invest may have to be traded off against redistributive tax policies.

### **3.1.4 FOREIGN EXCHANGE**

Foreign trade plays a critical role in many of the less developed economies, with limited internal markets, foreign trade involvement permits greater specialization, economies of scale and exercise of comparative advantage. In addition, foreign exchange earnings allow the purchase of certain products (such as machinery and equipment) which are needed for the development process but for which the necessary technology is not available domestically. Another contribution of exports to development may be the provision of an expanding market around which "linkage" investments may be made, thereby creating an "export-led" nexus of development. Thus, public policy must be concerned with the division of resources not only between consumption and investment but also between domestic and traded products; and among traded products there are both import-competing and exported goods. The tax structure also has a part to play in the general allocation process embodied in the development plan.

### **3.1.5 BALANCE AND BOTTLENECKS**

As economic development proceeds, various bottlenecks or limitations to the growth rate may crop up. For example, it has been suggested that in the early stage, the rate of internal saving is the controlling factor. As the rate of saving, and with it the growth of the economy, increases (aided, perhaps, by capital inflow from abroad) the absorptive capacity of the economy becomes the limiting factor. i.e., all the supportive factors which are needed to render the investment productive. Finally, the development process begins to create strains in the balance of payments, outstripping the capacity of the economy to earn foreign exchange to meet imports through exports. Thus, the resources made available for development purposes may go to waste because of these bottlenecks. A sound development plan should therefore endeavour to keep the process running smoothly by a policy of balanced growth. Tax policy in particular may be employed to encourage capital inflow and influenced the level of imports and exports.

### **3.1.6 ROLE OF FISCAL SYSTEM**

It is evident that the fiscal system plays a multifold role in the process of economic development. The level of taxation affects the level of public saving and thus the volume of resources available for capital formation. Both the level and the structure of taxation affect the level of private saving. Public investment is needed to provide infrastructure types of investment. A system of tax incentives and penalties may be designed to influence the efficiency of resource utilization. The distribution of tax burdens (along with the distribution of expenditure benefits) plays a large part in promoting an equitable distribution of the fruits of economic development. The tax treatment of investment from abroad may affect the volume of capital inflow and the rate of reinvestment of earnings there from and the pattern of

taxation of imports and exports relative to that of domestic products will affect the foreign trade balance.

### **SELF ASSESSMENT EXERCISE**

Discuss the important factors required for development purpose in a typical less developed economy.

## **3.2 FISCAL POLICY, STABILITY AND GROWTH**

The role of fiscal policy in securing stability and growth in the LDCs is of fundamental importance. This starts with the consideration of macro aspects of the problem.

### **3.2.1 REVENUE REQUIREMENTS**

It is helpful to view the problem in terms of a fully employed economy and to focus on the role of fiscal policy as a means of raising the domestic savings ratio. In making a first approximation to the amount of tax revenue needed to achieve a certain target rate of growth, differences between various sources of tax revenue are disregarded. Suppose that the objective is to achieve a 2 percent annual rate of growth in income per head. With a 2 percent annual growth rate of population, national income must then grow at slightly above 4 percent per year. This target rate of growth requires a certain rate of capital formation or investment expenditures as a percentage of national income. This ratio may be loosely estimated by the use of an incremental capital-output ratio.

Having made this first approximation to its revenue needs, the government must decide whether such a target is feasible and can be attained under any realistic tax reform programme. This decision will depend on the institutional framework, the capabilities of tax administration and the political will to make the necessary tax assessments stick. But two points should be noted. First, a very large effort is required to raise the revenue-income ratio by even one percentage point. Second, a development plan which is too ambitious to be implemented and requires more than the tax system can reasonably be expected to produce may be worse than no development plan at all, for it invites the waste of uncompleted projects and the danger of inflation, not to mention the social repercussions arising from unfulfilled expectations.

In addition to the highly unequal distribution of income, two other features stand out. First, a very substantial share of total income goes into "luxury" consumption. Defining luxury consumption as per capita consumption in excess of the average per capita consumption and taking total consumption to be 95 percent of total income, it appears that luxury consumption accounts for about 36 percent of income. This means that luxury consumption provides a substantial potential reserve for additional taxation. Ideally, this taxation would be applied in the form of a personal consumption tax but few if any LDCs could do so effectively. Two shortcomings of this approach need to be noted. For one thing, there still remains the problem of detrimental effects on work incentives. Such effects may be less in the case of consumption taxation than with progressive income taxation, but not eliminated. For another, progressive consumption taxes can reduce inequality of consumption but not inequality of income and wealth. Since the distribution of income and wealth is also significant in securing a broad sharing of development gains. Progressive consumption taxes cannot entirely replace progressive income and wealth taxation. A proper balance between these forms of taxation is important.

### **3.2.2 FOREIGN BORROWING**

Prior consideration was given to the role of loan finance in economic development when discussing public debt, but the problem should be noted once more in the present context. The earlier conclusion was that development requires capital formation and that capital formation requires saving. Public investment which is financed by borrowing does not add to capital formation if it merely diverts funds otherwise available for private investment. This recognition also underlies the preceding model on the basis of which the required rate of taxation was determined. The situation is different, however if

borrowing is from abroad. In this case, additional resources become available as borrowing is accompanied by increased imports. This borrowing provides additional resources for investment and permits financing a given growth rate with a lower rate of tax and a higher rate of current consumption. While the net gain to future generations will be less than it would have been with tax finance. Their surrender of consumption (to service the foreign debt) should be less burdensome than tax finance would have been to the initial generation. Because of this growth, the future cutback in consumption is made out of a higher level of income and since the marginal utility of consumption declines with rising consumption levels the resulting burden will be less severe. It is thus the income gain to domestic factors which renders foreign borrowing an important instrument of development policy.

### **3.2.3 AGGREGATE DEMAND, INFLATION, AND EMPLOYMENT**

The above discussion was based on the assumption of a fully employed economy, in this setting; the appropriate level of aggregate demand is given by the available level of output as valued at current prices. The basic rule for fiscal and monetary policy in this case is to let aggregate expenditures rise with the growth in full-employment output, neither faster nor slower. We now consider two ways in which this conclusion may be qualified:

- (i) Inflation as a Source of Saving: It has been argued that some degree of inflation will contribute to development because it may impose forced saving upon consumers. If credit expansion finances increased capital formation (public or private) rising prices reduce the real income of consumers, thus lowering consumption in real terms. In this way, inflation may serve to transfer real resources to capital formation. Such could be the outcome but one hesitates to prescribe it as a policy guide. For one thing, inflationary credit creation may be used to finance consumption (especially public consumption) rather than capital formation. For another, the "inflation tax" is among the least equitable of all taxes. Moreover, the inflationary process easily becomes a habit and leads to distortion of investment decisions. Perhaps inflationary expectations may lead to a reduction in private saving propensities. For these and other reasons, inflation cannot be recommended as a legitimate approach to development policy.
- (ii) Foreign capital import may bring foreign control and retard the development of domestic managerial talent.

### **3.2.4 UNDEREMPLOYMENT AND UNEMPLOYMENT**

There may be a preoccupation with whether unemployment in LDCs is of a kind that can be remedied by an increase in aggregate demand, as is frequently possible in developed countries. This problem arises especially in the context of agriculture and migration to urban areas. It is widely observed in LDC that there is a surplus of agricultural labour in the sense that labour is only partially employed, except at harvest time. Can such labour be drawn into industrial employment by increased demand based on a higher level of expenditures? The answer depends on the wages which such labour could obtain outside agriculture. If labour productivity, is low, the gain might not suffice to offset the increased costs which are incurred in movement from the farm. The problem may, thus is one of low productivity rather than of employment; and if this is so, the remedy lies in capital formation and increased productivity rather than in a higher level of expenditures.

The existence of heavy urban unemployment may come about as the result of out-migration attracted by what appear to be high wages in the industrial or urban sector, but minimum wage legislation or union demands may place a floor below such wages which in turn may make it impossible to absorb the labour influx. A remedy lies in tax provisions which counter the overpricing of labour in the market. At the same time, these difficulties do not preclude the existence of genius "Keynesian" unemployment which can be met by more expansionary demand policy.

## **SELF ASSESSMENT EXERCISE**

Discuss the issues related to the role of fiscal policy in securing stability and growth in the LDCs.

### **3.3 TAX-STRUCTURE POLICY**

We now turn to more specific issues of tax policy, beginning with a consideration of tax effort.

#### **3.3.1 TAXABLE CAPACITY AND TAX EFFORT**

While it is important to know what overall level of tax revenue is required to secure a given growth target, the feasibility of achieving that level of taxation is an important consideration which must be allowed when the target is set. Tax policy must be considered along with other aspects of development policy, but it must not be looked at as the dependent variable in the system which will automatically respond to the requirements placed upon it. How, then, can one judge what tax effort a country is capable of, and how can its tax performance be measured. We have noted in the previous discussion of tax-structure development that the tax to GNP ratios in less developed countries are typically quite low, ranging from 8 to 18 percent. Why is it that the tax effort in developing countries is so much lower, and does the lower ratio in fact signify a lower effort? The answer depends on what the term "tax effort" is taken to mean. An international lending agency may wish to make its aid contingent on the recipient country's making an adequate tax effort of its own. The lending agency may then require a country with a higher per capita income to show a higher revenue ratio in order to demonstrate the same level of tax effort.

Apart from the level and distribution of income, the availability of "tax handles" is related to the economic structure of the country. Thus, the administration of an income tax is much more difficult where employment is in small establishments. Profits taxation is not feasible until accounting practices attain minimal standards. And it is difficult if firms are small and unstable product taxes cannot be imposed at the retail level if retail establishments are small and impermanent. Effective land taxation is difficult where food is home-consumed, the agricultural sector is largely non-monetized, and land surveys are inadequate in providing proper valuations. On the other hand, taxation is simplified in a highly open economy where imports and exports pass through major ports and thus can be readily established by tax authorities. Finally, the feasibility of taxation depends upon how society views the need for compliance, the extent to which the courts are willing to enforce tax laws, and the availability of a competent and honest staff of tax administrators. Resort to tax farming, i.e., a system where collectors are given a percentage of their tax takes as an incentive, may be a helpful short-run device, as may be the assignment of revenue quotas to tax officials. But these are not methods on which a durable and equitable tax structure can be built. For these and other reasons, a realistic appraisal of a country's tax effort has to allow for the tax handles which are available to it.

#### **3.3.2 TAX-STRUCTURE DEVELOPMENT**

The problems associated with the design and administrations of various taxes differ with the structure of the economy in which they are applied and with its climate of public attitudes toward taxation. However, they also differ with stages of economic development and some general tax-structure characteristics in relation to per capita income may be observed. In most countries tax structure, the importance of taxes on external trade (mainly customs duties) and of taxes on domestic production and sales for low-income countries as well as the low share of income taxes is always visible. As per capita income rises the importance of income taxes increases relative to that of customs duties and taxes on domestic sales and production. Payroll taxes also rise in relative importance as per capita income increases.

In addition to changing shares, the nature of the various taxes is also subject to change. Thus, taxes classified as income taxes in low-income countries are frequently capitation taxes which bear little resemblance to the personalized individual income tax of developed countries. Similarly, the so-called business income tax is often closer to a sales tax than to a profits tax as applied in the developed countries.

### **3.3.3 INDIVIDUAL INCOME TAX**

Turning to particular taxes, we begin with the individual income tax. For various reasons, the individual income tax does not and cannot be expected to occupy the central position in the tax structure of LDCs which it typically holds in the developed countries. Nevertheless, the income tax should be established early and strengthened as development proceeds. It is elastic to growth in GNP and therefore a promising revenue source for development finance. Its contribution to total revenue in Latin American countries typically ranges around 20 percent and is thus a significant part of the revenue. This is true even though the feasibility of collecting a tax on wage and salary income in LDCs tends to be restricted to government, foreign corporations and the rather limited group of large local enterprises. Employees of small establishments and the large group of self-employed, especially in agriculture, typically remain outside the circle of the income tax. In part, this reflects exemption levels which are set high relative to average income, but it is also the result of ineffective enforcement and administration.

Difficulties in reaching capital income are even greater and there is a substantial lag of final tax payment behind the income year. Use of tax withholding helps to speed up tax collections and is all to the good but its applicability tends to be limited to the very types of wage and salary income which lend themselves to easy enforcement. This payment lag enjoyed by capital income is a substantial advantage where inadequate interest penalties are charged for delay and the real value of tax debts is eroded by inflation. Income tax administration is bedeviled by the problem of inflation. It is not infrequent for developing countries to experience price level increases between 10 and 30 percent per year. In adaptation to this income tax administration may provide for an automatic annual increase in exemption levels and rate brackets as prices rise, so as to keep the relation between marginal rates and real income constant. As a result, the effect of inflation on income tax equity is neutralized but the built-in inflation check exerted by an unadjusted progressive income tax is reduced.

The problem of capital gains, especially in relation to land and buildings, is of considerable importance in developing countries where rapid urbanization gives rise to increasing land values, much as was observed toward the close of the nineteenth century in the United States. To meet this problem, a capital gains tax on real estate, i.e. buildings and land, is administered as a separate tax. There is a strong economic and equity case for such a tax if applied to gains from land (as distinct from improvements).

### **3.3.4 BUSINESS INCOME TAX**

The most difficult problems arise in the effective taxation of business income, whether under a separate corporation profits tax or as applied to partnership and proprietorship income under the individual income tax. Where business accounting has not been developed to a level sufficient to measure profits with reasonable accuracy, other methods have to be applied. Thus, many countries use a presumptive rather than a direct approach to profit determination. This may take the form of a presumptive profit margin on sales, with different margins stipulated for various industries. This method which is widely used in Asian countries, transforms the profits tax into a type of sales tax, this shift occurs since tax liability is a function of sales and the presumptive rather than actual margin,

In other situations, the presumptive measure of profits is based on such indices as floor space and

location by blocks, a practice also to be found in the tax tradition of European countries especially with regard to professional income. In the case of agriculture, acreage or head of cattle may be used as the presumptive base. At the same time. "Stick and carrot" techniques might be used to reward the conscientious taxpayers by the use of so-called blue returns, while penalizing the laggard payers by penalty rates. Tax reformers are frequently tempted to overlook the importance of improving 'the techniques of presumptive taxation in favour of preoccupation with technical refinements of corporation taxation which, though important in developed countries apply to only a small part of the business sector in the LDCs. Furthermore, the legal forms of business organization frequently differ. In Latin American countries for example continental European rather than common-law traditions prevail, while in Asian countries a quite different system of property law may apply; and practices appropriate for a country such as the United States may not be applicable to LDCs, given their traditions and current state of development."

### **3.3.5 LAND TAXES**

Since the agriculture sector in most LDCs is large, the problem of land taxation remains of major importance, one basic question is whether the tax should be imposed on the value of land, on actual income, or on the potential income which the land could yield under full utilization. In a perfectly competitive system, the three bases would be interchangeable since land values would equal the capitalized value of its income, and actual income would equal the potential. In reality such is not the case, land is frequently underutilized and held for speculative purposes. Thus, the three bases yield substantially different results. Moreover, the income tax is rarely applied to the agricultural sector, so that land revenue frequently serves as a combined income and land tax including not only the rent of land but also labour and improvement (capital) income in its base.

Whichever approach is taken, the availability of adequate land surveys and their maintenance on an up-to-date basis are an essential requirement for an efficient system of land taxation. Frequently, such surveys are not available, so that only haphazard methods of assessment can be applied.

### **3.3.6 WEALTH AND PROPERTY TAXES**

In addition to land revenue, the taxation of urban real estate is an important part of the tax base, especially as urbanization proceeds. A good case can be made for progressive taxation of residential property combining multiple residences in one base so as to supplement the system of commodity taxation on luxury consumption other than housing. Beyond this, wealth taxation of the net worth type is a frequent component of the tax structure in LDCs. Although such taxes may in the end prove to be little more than part of the system of real property taxation, with intangibles largely escaping the tax base there a useful supplement to income taxation as it applies to capital income. Real capital is visible and once accounted for under the wealth tax, earnings from there may be traced to its owners under the income tax.

### **3.3.7 COMMODITY TAXES AND TARIFFS**

The design of commodity taxation involves three major problems vis: what products should be taxed and at what rates; at what stages such taxes should be imposed and how taxation of domestic products should be related to Import duties. As noted previously, the twin objectives of protecting savings and of modifying a highly unequal state of distribution point to the taxation of luxury consumption as the most obvious solution. Given that implementation of a personal type of expenditure tax is hardly feasible for LDCs, the situation calls for taxation of luxury consumption. If this view is correct, the basic requirement is not for a comprehensive and flat-rate sales tax but for a system of sales taxation with differing rates. The implementation of progressive consumption taxation by differentiation between products thus depends on the existence of products with sharply different income elasticity's, a precondition which appears to be met in developing countries.

The stage or stages at which commodity taxes are to be imposed has to be decided on grounds of administrative feasibility and thus depends upon it. It should be noted that the distinction is not between types of products which, on nutritional or ethical grounds may be considered as essential, but simply between commodities which weigh more heavily in high-income and low-income budgets the structure of the particular economy. With a multiple-stage tax of the value-added type, failure to reach the retail stage involves only a partial revenue loss not the total loss that would be the result under a retail sales tax. Moreover, use of the invoice method contributes to better compliances, on the other hand taxation of final products at differential rates tends to be more difficult under the value-added approach where products comprising an important part of the tax base originate in relatively large manufacturing establishments. There remains the need for coordinating domestic excises with import duties. In their desire to impose heavier burdens on luxury consumption, LDCs frequently place higher import duties upon luxury products. At the same time, this measure often goes with a failure to match such duties by corresponding excises on home-produced luxury goods. Thus, luxury tariffs tend to provide protection to domestic substitutes. This is clearly poor policy. If protective tariffs are to be used to permit domestic infant industries to develop, such industries should be chosen according to their development potential and not as a side effect of luxury taxation. The best approach may well be to use largely uniform tariff rates while including luxury imports in the tax base of the domestic excise system. Another aspect of tariff policy which requires critical review is the practice of excluding domestically used capital goods from customs duties. In a situation where, for various reasons the cost of capital tends to be undervalued relative to the cost of labour; this practice heightens price distortion.

### **SELF ASSESSMENT EXERCISE**

Discuss issues related to tax policy in development finance.

### **3.4 TAX INCENTIVES AND EXPENDITURE POLICY**

The final important issues to be considered in development finance is tax incentives and expenditure policy. These are also important issues in development finance as it determines the availability of resources at government disposal for development purpose.

#### **3.4.1 TAX INCENTIVES**

The twin objectives of economic growth and reduction of inequality can be secured best by reliance on progressive consumption taxes; but equity calls for this approach to be combined with the taxation of capital income under a progressive income tax. Given the potential conflict of the latter with investment incentives it is not surprising that much attention has been given to various devices by which detrimental investment effects can be minimized. How far a country should trade distributional equity for growth gains is a matter of policy judgment which transcend considerations of tax policy only.

Tax relief for investment which does not pay for itself in generating additional growth not only involves less revenue without gain, but, worsens the state of income distribution by giving the relief to high income. Judged on these grounds, tax incentives to investment have been generally wasteful and inequitable, so much so that many observe have been led to reject all incentive devices. But notwithstanding the dismal experience, total rejection is not justified. Political pressures for tax incentives will prevail no matter what the technician may say, and this being inevitable, they may as well be designed as efficiently as possible.

#### **3.4.2 DOMESTIC INCENTIVES**

In dealing with the incentive problem, it is helpful to distinguish between domestic incentives and the incentive problem as it relates to foreign capital in particular. Domestic incentives might be related to investment in general or they might be limited to investment in selected industries or regions. Finally,

incentives may be designed to stimulate exports and to strengthen the balance of payments. General investment incentives may take the form of investment credits or accelerated depreciation similar to the devices used in developed countries. In addition, LDCs frequently offer tax holidays during which profits from new enterprises are tax-free for an initial period of, say, five to seven years. This method relates the value of the incentive to high initial profitability, which may run counter to the need for stable and more long-run types of investment. For the case of new investment by existing firms, there is the further difficulty of distinguishing between earnings attributable to the new and old component' of their capital stock. This problem is avoided by an investment credit or investment grant approach. Moreover, it is a poor policy for government to make long-run commitments to tax subsidies especially where it is hoped that there will be a declining need for such subsidies in the future.

While the effectiveness of general investment incentives is questionable, there is more reason to expect that incentives limited to particular sectors or industries will be effective in diverting capital to such industries, the big problem here lies in how to select the industries which are to be given preferential treatment. Presumably, the industries which should be chosen are those which play a strategic role in development and which, without special favour, will remain under expanded. Undoubtedly there exist external economies in the development process which are not allowed for in private investment decisions; and imperfect capital markets may misdirect investment even without externalities. Wise correction of such investment errors would thus be desirable. Frequently the list of eligible industries is so broad as to involve little selection. In other instances, selection reflects political pressure groups, and in others, incentives are given to sustain the market for public enterprises, such as steel mills, which should not have been constructed in the first place. Although selective use of incentives is good in principle, efficient application is hard to find.

### **3.4.3 INCENTIVES TO FOREIGN CAPITAL**

Foreign capital plays an important role in development policy, and tax incentives may be helpful in channeling it to the uses which are most desirable for the whole country. From the national viewpoint, the role of tax incentives to foreign capital differs from that of incentives to domestic capital. While the latter merely involve transfers between the treasury (which loses revenue) and the investor (who gains), tax relief granted to foreign investors reduces the whole country's share in the profits earned by foreign capital. This loss must therefore be compensated for by the gains from additional capital influx if the tax incentive is to pay its way. The design of incentives may be helpful in directing foreign capital into such uses as are advantageous to the host country. The gains to be derived from foreign capital lie in the increased earnings for domestic factors of production to which the foreign capital gives rise. There is little advantage to the host country in foreign capital which brings its own resources with it and uses the foreign location as a product site only. Tax incentives should be linked to domestic value which the foreign capital induces.

Another device which would render incentives effective to foreign investors who intend to repatriate is the so-called tax-sharing arrangement. Under this provision, the country of capital ownership would extend a credit, upon repatriation, equal to the full tax in the LDC even though a lesser tax or no tax is paid under the incentive arrangement. This approach, however, lacks the incentive for reinvestment and undermined taxation of profits.

A final point arises in connection with competition among LDCs for foreign capital. To the extent that one country outbids another by offering larger incentives, LDCs as a group stand to lose. Some degree of cooperation is desirable to avoid self-defeating tax competition. This is one of the important roles of common market arrangements among groups of LDCs.

### **3.4.4 EXPORT INCENTIVES**

Tax incentives for exports are a popular device to assist in the development of foreign markets and to strengthen the balance of payments. Such incentives, to be effective should be related not to total foreign sales or profits there from as is the typical practice, but to domestic value added. It is only the late component of foreign sales, and not the re-export of imported material or intermediate goods, which adds to a country's foreign exchange earnings.

### **3.4.5 EXPENDITURE POLICY**

The role of expenditure policy in economic development has been explored less extensively than that of tax policy, and comparative data are more difficult to obtain. However, comparisons of the patterns of expenditure budgets of African, Latin American, and Asian countries with those of European countries, some evidence regarding the role of per capita income is obtained. Low-income countries direct a higher share of expenditures to education and health services and a lower share to transfers. The higher share for education to some degree reflects the higher cost of educational services in these countries, the higher share of transfers in high-income countries reflects the more developed social security systems.

The strategic role of public investment in economic development is based in part on the undeveloped state of private capital markets and in part on local scarcity of entrepreneurial talent; it is also based on the fact that the type of investment needed at the earliest stages of development frequently includes very large outlays, such as those involved in the development of transportation systems or the opening up of undeveloped parts of the country. Moreover, infrastructure investment of this sort carries external benefits which call for public provision. It is not surprising, therefore, that the development of public investment performs a major function in the design of development plans in LDCs. In this context, the use of cost-benefit analysis is of great importance. Developing Countries can ill afford to waste scarce resources, and yet efficient project evaluation is a difficult task. In one respect, cost-benefit analysis is more readily applied in developing than in developed countries. This is because public investment is typically aimed at the provision of intermediate goods. the value of which may be measured in terms of their effects upon the prices of privately provided goods. Thus, the return on transportation or irrigator projects may be appraised in terms of the resulting reduction in the cost of goods as they reach the market. This is a measure which cannot be applied where public outlays go to provide final consumption goods. Bur in other respects, the task of evaluation is more difficult.

Another important factor is proper determination of the discount rate. With private capital markets not fully developed, use of a "social rate" may be inevitable. Considerations suggesting the presence of external benefits indicate that the social rate should be set below the level of rates prevailing in the market, thus pointing to a higher rate of capital formation and the choice of longer-term projects. Pointing in the other direction is the fact that the cost of forgoing current consumption is very high at low levels of income, yet, when the gain from postponement is realised in the future, the marginal utility of consumption will be less since income is higher. This fact tends to be overlooked in individual savings decisions but should be allowed for by government. But here, as in other matters of discount rate determination, cruder approaches are likely to be used. in the typical development context, the government may find itself confronted with the practical necessity of determining the politically acceptable minimum path of consumption over the next five and may derive the discount rate from there.

Human investment deserves particular consideration in the development context. Education programs are important not only as a matter of growth policy but also for their important bearing on how the gains from growth will be distributed both among income groups and among various sectors of the economy. Studies have shown exceedingly high rates of return on educational investment in developing countries, thus pointing to the particular importance of this form of capital formation, but it is essential that the

educational inputs be designed to meet the country's need for specific labour skills.

## **SELF ASSESSMENT EXERCISE**

Discuss the importance of tax incentives and expenditure policy in development finance.

### **3.5 Tax Laws and Administration in Nigeria**

#### **3.5.1 Sources of Nigerian Tax Laws**

The general sources of Nigerian tax laws are as below.

- (i) Legislations such as Personal Income Tax Act (1979), Companies Income Tax Act (1961), Petroleum Profit Tax Act (1959), Income Tax Management Act (1961), etc;
- (ii) 1999 Federal constitution;
- (iii) Court judgements;
- (iv) Circulars and practices of inland revenue officials;
- (v) Opinions of income tax experts;
- (vi) Budget and pronouncements of relevant ministries.

However, the main legislative sources of tax laws are:

- (i) **Taxation of Personal Income** – the 1979 constitution canceled all the state laws on personal income tax and promulgated a uniform law known as Personal Income Tax Act of 1993. It was aimed at replacing the Income Tax Management Act of 1961, Income tax (Armed forces and other persons' special provision) act, 1972 and the Income Tax Management (Uniform taxation provisions) act, 1975 (Soyode & Kajola, 2006 in Jugu *et.al.*, 2012).
- (ii) **Company Taxation** – the law governing this has undergone many amendments. It was first enacted in 1939 but repealed and replaced with the Income Tax Ordinance of 1943. By 1961, another legislation known as Company Income Tax Act was enacted. This was replaced by Company income tax decree of 1979. Other amendments that follow include Decree 4 of 1985, Decree 12 of 1987, Decree 31 of 1989, Decree 55 of 1989, Decree 21 of 1991, Decree 63 of 1991, Decree 3 of 1993, and Decree 30, 31 & 32 of 1996.
- (iii) **Capital Taxation** – There are two laws that govern the administration and assessment of this. The Capital Gains Tax Act (CGTA) of 1967 and Capital Transfer Tax Act (CITA) of 1979, which have witnessed several amendments over the years. For example, the rate of Capital Gains Tax was reduced from 20% to 10% due to one of these amendments. Some objectives of these amendments were to stimulate the activities in the capital market, encourage capital formation through investment and prompt efficient management arising from merger, acquisition and take over. However, CITA was abrogated through the 1996 budget in the interest of the country.
- (iv) **Petroleum Profit Taxation** – The upstream sector of the petroleum industry in Nigeria started in 1957 and made its first export of oil in 1958. This create the need to have a separate and exclusive legislation for the industry. The Petroleum Profit Tax Act (PPTA), 1959 was enacted, and between 1966 and 1979, it underwent series of amendments which were consolidated into the Petroleum Profits Tax Act, Cap 354, Laws of the Federation of Nigeria (LFN) 1990. Various amendments have also been done on the PPTA (1990) through various decrees such as (a) Petroleum Profit Tax (amendment) decree No. 104 of 1993; (b) Petroleum Profits Tax (amendment) decree No. 31, 1996; (c) Petroleum Profits Tax (amendment) decree No. 18, 1998; (d) Petroleum Profit Tax (amendment) decree No. 30, 1999.

- (v) **Consumption taxation:** This was formerly legislated by Sales Tax Decree No. 7 of 1986, which has been replaced by Value Added Tax (VAT) decree No. 102 of 1993. The legislation takes care of indirect taxes that pass the burden of tax to the final consumer.
- (vi) **Education Tax:** The education sector has a form of tax known as Education Tax, which is legislated by the Education Tax Decree No. 7 of 1993. The primary objective of having a sectoral tax for education is to raise funds for the upgrading of the nation's educational infrastructure.

### 3.5.2 Tax Laws in Nigeria

The following laws governed taxation in Nigeria:

- (a) Personal Income Tax Act (PITA) *Cap.* P8, *LFN* 2004 – this enables the imposition of tax on incomes of individuals, sole traders and partnerships. For example, Pay-As-You – Earn (PAYE) by employees is covered by the provisions of this act.
- (b) Companies Income Tax Act, (CITA) *Cap.* C21, *LFN* 2004 – This imposes tax on the incomes of companies other than sole proprietorships, partnerships, and companies engaged in downstream petroleum operations. Example of this is corporation tax- with rate fluctuating between 30% - 45%, depending on yearly fiscal policies of the federal government.
- (c) Petroleum Profits Tax Act, (PPTA) *Cap.* P13, *LFN* 2004 – This imposes tax on the profits of companies engaged in upstream petroleum operations.
- (d) Value Added Tax Act, (VAT) *Cap.* VI, *LFN* 2004 – which replaced sales tax in 1994. It imposes tax on the supply of goods and services by businesses that are not specifically exempted from the payment of such a tax.
- (e) Stamp Duties Act, (SDA) *Cap.* 58 *LFN* 2004 – these are charges on all contract documents listed in the Act.
- (f) Education Tax Act, (ETA) *Cap.* E4, *LFN* 2004 – this imposes education levy/tax on the assessable profits of all registered companies in Nigeria.
- (g) Capital Gain Tax Act, (CGTA) *Cap.* C1, *LFN* 2004 – this imposes tax on capital gains arising from the disposal of chargeable assets listed in the act

### 3.5.3 Tax Administration in Nigeria

The administration of taxes in Nigeria rests on various tax authorities depending on the type of tax under consideration. Generally, there are three tax authorities in Nigeria as follows: (a) The Federal Board of Inland Revenue (FBIR), (b) The State Internal Revenue Board (SIRB) and (c) The Local Government Revenue Committee. The principles of fiscal federalism give the three tiers of government the right to collect taxes within their areas of jurisdiction. The enabling law in respect of each type of tax contains a provision as to the body charged with the administration of such a tax.

#### 3.5.3.1 Organs of Tax Administration

1. **Federal Board of Inland Revenue (FBIR):** The administration of taxes on the profits of all incorporated companies, and income tax of the Armed Forces and residents of the Federal Capital Territory is vested in the FBIR whose operational arm is known as the Federal Inland Revenue Service (FIRS). This is covered by section 1(1) of CITA. The functions of the *FBIR* board include:
  - (i) Administration of *CITA* and other tax acts as may be vested in *FBIR*;
  - (ii) Assessment and collection of companies' income tax;

- (iii) Accounting for all amounts collected in a manner to be prescribed by the minister of finance;
- (iv) Advising the federal government of Nigeria through the minister of finance on tax matters including amendments to tax laws; and
- (v) Issuing guidelines on the interpretation of the provisions of the *CITA* and other tax laws.

## 2. State Board of Internal Revenue (SBIR)

Section 87 of *PITA* provides for the setting up of a board of internal revenue for each state whose operational arm is to be known as the State Internal Revenue Service (SIRS). The state board of internal revenue has the following responsibilities:

- (i) Ensure the effectiveness and optimum collection of all taxes and levies due to the government, under the relevant laws;
- (ii) Undertake such things as may be deemed necessary and expedient for the assessment and collection of taxes and shall account for all monies so collected in a manner to be prescribed by the commissioner of finance;
- (iii) Make recommendations, where appropriate, to the Joint Tax Board on tax policy, tax reforms, tax registration, tax treaties and exemptions as may be required from time to time;
- (iv) Control the management of the *SIRS* on matters of policy, subject to the provisions of the law setting up the *SIRS*.
- (v) Appoint, promote, transfer and impose discipline on employees of the *SIRS*.

## 3. Local Government Revenue Committee

The local government revenue committee was established by the provisions of section 90 of *PITA* which states that each local government should have Local Government Revenue Committees (LGRCs). The functions of LGRC include:

- (i) The Committee is responsible for the assessment and collection of all taxes, fines and rates under its jurisdiction and accounts for all monies collected in a manner to be prescribed by the chairman of the local government.
- (ii) The revenue committee is autonomous of the local government treasury department and responsible for the day-to-day administration of the department which forms its operational arm.

## 4. Joint Tax Board (JTB)

Section 86 of *PITA* provides for the establishment of the *JTB* which comprise of the following:

- (a) The chairman of the *FBIR*, who also serve as the chairman;
- (b) One member from each *SBIR*, being a person experienced in income tax matters nominated either by name or office, from time to time, by the commission charged with the responsibility of matters relating to income tax in the state in question;
- (c) The secretary, who is not a member of the board, and is appointed by the Federal Civil Service Commission (FCSC)
- (d) The legal adviser of *FIRS* acts as the legal adviser to the *JTB*.
- (e) Any seven members or their representatives shall constitute a quorum.

The functions of *JTB* include:

- (i) exercise the powers or duties conferred on it by the *PITA* and other acts;
- (ii) advise the federal government, on request, in respect of double taxation arrangement with any other country;
- (iii) advise the federal government on request, in respect of rates of capital allowances and other taxation matters having effect throughout Nigeria in respect of any proposed amendment to *PITA*;

- (iv) promote uniformity both in the application of *PITA* and in the incidence of tax on individuals throughout Nigeria; and
- (v) impose its decisions on matters of procedure and interpretation of *PITA* on any state for purposes of conforming to agreed procedures or interpretations.

#### 5. Joint State Revenue Committee (JSRC)

Section 92 of *PITA* establishes the *JSRC* for each state of the federation. The *JSRC* comprises:

- (a) the chairman of the *SIRS* as the chairman;
- (b) the chairman of each of the *LGRC*;
- (c) a representative of the Bureau for Local Government Affairs, not below the rank of a director;
- (d) a representative of the Revenue Mobilisation Allocation and Fiscal Commission (RMAFC), as an observer.
- (e) The state sector commander of the Federal Road Safety Commission (FRSC), as an observer;
- (f) The legal adviser of the *SIRS*;
- (g) The secretary of the committee who shall be a staff of the *SIRS*.

The functions of the committee are as listed below.

- (i) Implementing the decisions of the *JTB*
- (ii) Advising the *JTB*, and the state and local governments on revenue matters;
- (iii) Harmonising tax administration in the state;
- (iv) Enlightening members of the public generally on state and local government revenue matters;
- (v) Carry out such other functions as may be assigned to it by the *JTB*.

#### 3.5.4 Tax Jurisdictions

A. Taxes collected by the Federal Government: The FBIR is constituted under section one of CITA to assess and collect the following taxes on behalf of the federal government:

- (i) Companies income tax of limited liability companies (incorporated companies);
- (ii) Withholding tax on companies and residents of the FCT, -Abuja, and non-residents;
- (iii) Petroleum profits tax, VAT and education tax
- (iv) Capital gains tax and stamp duties on corporate bodies, residents of the FCT and non-residents;
- (v) Pay – As – You – Earn (PAYE) of members of the armed forces,
- (vi) Police force, residents of the FCT and the staff of the ministry of foreign affairs and non-residents.

B. Taxes and Levies collected by the State Government: The SBIR have the power to assess and collect the following categories of taxes and levies:

- (i) Pay – As – You – Earn (PAYE), direct taxation (self-assessment and withholding and capital gains taxes of individuals.
- (ii) Stamp duties on instruments executed by individuals
- (iii) Pools, betting and lotteries, gaming and casino taxes
- (iv) Road taxes and naming of street registration fees in the state capital
- (v) Business premises registration fees
- (vi) Development levy, right of occupancy fees and market taxes and levies

C. Taxes and Levies collected by the Local Governments: The following taxes and levies are collected by the local government level:

- (i) Shops, kiosks rates and tenant rates (ii) On and off liquor license fees (iii) Marriage, birth and death registration fees (iv) Naming of street, right of occupancy fees for towns and lands in the rural areas (v) Market and motor park levies (vi) Domestic animal license fees and cattle tax (vii) Merriment and road closure levy (viii) Radio and television license fees (ix) Wrong

parking charges (x) Customary burial grounds permit fees (xi) Religious places establishment permit fees (xii) Signboard and advertisement permit fees.

## 4.0 Conclusion

From our discussion of development finance, we have been able to identified that:

- Fiscal policy in less developed countries differs in important respects from that in highly developed countries. This variation is due to the fact that the economic and social setting in LDCs is different.
- The fundamental need for capital formation and the difficulty of generating the required level of saving out of a low per capita income are dominant factors.
- Measures to induce technological improvement, to encourage enterprise, and to develop institutions making for more efficient use of resources are of major importance.
- Pursuit of these objectives is made difficult by social and political factors as well as deficient administrative capabilities.
- The requirement for a tax structure which secures an adequate level of saving must be reconciled with the requirement for tax equity.
- The tax administration in Nigeria is a responsibility of federal, State and local governments.

## 5.0 Summary

This unit discusses the important requirements for development finance and the ingredients of development finance. It also discusses various problems and limitations of different means of development finance. For example, it shows that foreign trade is usually of prime importance, as is the need for foreign exchange to secure the necessary imported capital equipment. It also shows that measuring the contribution of the public sector to overall savings by the surplus in the current budget required that this surplus must equal the excess of required total saving over available private saving. These underscores the importance of fiscal policy in development finance. The unit further discusses tax laws and administration and highlighted different bodies charged with tax collection in Nigeria.

### SELF ASSESSMENT EXERCISE

Enumerate the functions of the bodies charged with the responsibility of tax administration in Nigeria.

## 6.0 Tutor-Marked Assignment

Submit a three-page write up on the sources of development finance and challenges of each source.

## 7.0 REFERENCES /FURTHER READINGS

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