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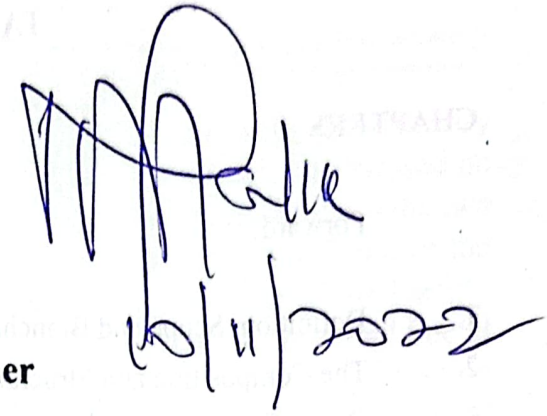
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CHAPTER 27
TAXATION AND PUBLIC EXPENDITURE

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Meaning and Scope of Public Finance

Public finance deals with government financial activities concerning revenue, expenditure and debt operations. It analyses government financial activities on the economy, corporate bodies and individuals. Thus, public finance deals with income and expenditure of government entity at any level be it central, state or local. It revolves around the role of government income and expenditure in the economy. Public finance is different from private finance. While public finance studies income, expenditure, borrowing and financial administration of the public, private finance studies income, expenditure, borrowing and financial administration of the individuals and private organizations. Another area of difference is the adjustment of income and expenditure. The private, especially individual, will prepare his expenditure on the basis of expected income during a specific period of time, usually one month. The government will first of all prepare the estimated expenditure then finds ways of raising income to finance the budgeted expenditure. The motives of public and private finances are also different. While public finance motive is to maximize public welfare, private finance motive is to maximize profit.

The scope of public finance has been classified into four by Prof. Dalton. This includes; Public income, public expenditure, public debts and financial administration.

Public Income

Public income refers to the income of the government which could be earned through the imposition of tax or other sources of income. Income from tax includes personal income tax, company income tax, sales tax, value added tax, poll tax and excise duties. While, the non-tax income includes interest income from lending money to other countries, rent and income from government properties, donations from world organisations, fees, fines and so on. This aspect of public finance studies methods of taxation, revenue classification, methods of increasing government revenue and its impact on the economy as a whole.

Public Expenditure

Public expenditure is the money spent by government entities. As a result of the functions perform by the government, money is usually expended on infrastructure, defense, education, healthcare, and so on for the growth and welfare of the country.

This area studies the objectives and classification of public expenditure, effects of public expenditure in different areas, effects of public expenditure on various factors such as employment, production, and growth.

Public Debt

When public expenditure exceeds public income, the gap is filled by borrowing money from the public, or from other countries or world organisations such as International Monetary Fund, World Bank, Paris clubs and London clubs of creditors. These borrowed funds are public debt.

This area of public finance explains the burden of public debt, why it is necessary and effect on the economy. It also suggests methods to manage public debt.

Financial Administration

As the name suggests this area of public finance is all about the administration of all public finance. That is, public income, public expenditure, and public debt. Financial administration includes preparation, passing, and implementation of government budget and various government policies. It also studies the policy impact on the social-economic environment, inter-governmental relationships, and foreign relationships.

Functions of Public Finance

Public finance performs the following three main functions; allocative, distributive and stabilization.

The Allocation Function

There are two types of goods in an economy – private goods and public goods. Private goods have a kind of exclusivity to themselves. Only those who pay for these goods can get the benefit of such goods, for example– a car. In contrast, public goods are non-exclusive. Everyone, regardless of paying or not, can benefit from public goods. For example – a road, street light. Once provided, they are provided for all. The allocation function deals with the allocation of such public goods. The government has to perform various functions such as maintaining law and order, defense against foreign attacks, providing health-care and education, building infrastructure, and so on. The performance of these functions requires large scale expenditure, and it is important to allocate the expenditure efficiently. Thus, the allocation function studies how to allocate public expenditure most efficiently to reap maximum benefits with the available public income/wealth.

The Distribution Function

There exists great disparities of income and wealth in different countries of the world. The distribution function of public finance seeks to reduce these inequalities as much as possible through redistribution of income and wealth. This can be done through: using progressive taxes, by charging higher tax from the rich and giving subsidies to the low-income earners. Such progressive taxes can be used to finance public services such as affordable housing, and health care. A higher tax can be applied to luxury goods or goods that are purchased by the high-income group, for example, higher taxes on luxury cars.

Thus, the distribution function of public finance aims at reducing the inequalities through redistribution of income and wealth.

The Stabilization Function

The attainment of macroeconomic objectives of steady economic growth, high employment, price and exchange rate stability may not be achieved automatically, hence, the need for economic/fiscal stabilization. Economic stabilization helps to prevent the economy from drifting away from equilibrium. Without stabilization policy, the economy tends to be subjected to substantial fluctuations and may suffer from sustained periods of unemployment or inflation. With growing international dependence, forces of instability may be transmitted from one country to another, which further worsen or complicates the problem. In one period, the level of expenditures may be insufficient to secure full

employment of labour and other resources. For various reasons, including the fact that wages and prices tend to be rigid downward; there is no ready mechanism by which unemployment will restore itself automatically (full employment may be achieved). Expansionary measures to raise aggregate demand are then needed. At other times, expenditures may exceed the available output under conditions of high employment and thus may cause inflation. In such situations, restrictive measures are needed to reduce demand. Furthermore, just as deficient demand may generate further deficiency, so may an increase in prices generate a further price rise, leading to renewed inflation.

TAXATION

Taxation is system of levying taxes: the system whereby taxes are levied on some types of income, earnings, or purchases.

Terminologies

Tax is a compulsory levy on the residents of a society by the government. Its payment is compulsory and imposed by various tiers of government on individuals, firms and organisations. It is only the government that can impose or levy taxes through its various agencies such as the Nigeria Customs Service and Federal Inland Board of Revenue (Nigeria).

Tax incidence is an economic term for the division of a tax burden between buyers and sellers. It deals with who bears the final burden of a tax. This has to do with the price elasticity of supply and demand. It is the consumers who bear the greater burden of the sales tax on an inelastic product while it is the producers who bear the burden of tax on elastic products.

Tax evasion refers to the illegal practice of not paying taxes either by not reporting income appropriately or reporting expenses not legally allowed or by not paying tax at all or providing false information or keeping two set of accounts books. Tax evasion is a criminal offence/tax fraud which involves criminal procedures of manipulating the tax form by declaring lower income or refusing to pay tax altogether.

Tax avoidance deals with minimizing of taxes payment through the use of legitimate tax deductions. The individual takes advantage of the loopholes in the tax system (regulations) and thus, manipulates by paying low tax.

Tax holiday refers to the period of tax exemption from state granted to companies/firms when they are about starting a business. Specifically, many Nigerian firms have enjoyed and still enjoying tax holiday. It could take the form of the granting of tax exemption to firms for 5 years for those who are engaged in priority areas such as health or the granting of tax exemption to firms for 7 years for those located in economically disadvantaged areas of the country.

Tax relief are the deductions that reduce the amount of tax to be paid by the tax payers.Therelief constitutes tax savings in the form of allowable deductions such as pension contributions, capital gains, and business losses.

Tax haven refers to country with favourable tax rates.

Tax structure refers to the tier or level at which tax laws are made and taxes collected. Presently, we have the Federal, State and Local governments having separate powers to enact and collect taxes imposed on taxable personsin Nigeria. The tax structure of an economy depends on its tax base, tax rate and how the tax rate varies.

Tax base is the amount of assets or income or properties in a certain area or

jurisdiction that can be taxed by a taxing authority. It can be on income or property. Tax base also refers to the total value of all income, property on which tax is charged. Tax rate is the percentage of the tax base that must be paid.

Types of Taxes

Taxes are classified into two broad categories namely: Direct Taxes and Indirect Taxes.

Direct Taxes

These are taxes on income or receipts and the incidence of such taxes fall directly on the tax payers. It is not possible for the person who pays the tax to shift the burden to someone else. Examples of direct taxes are personal income tax, company income tax, and poll tax. Direct tax can be used to redistribute income. There are three forms of direct taxes namely: progressive tax, proportional tax and regressive tax.

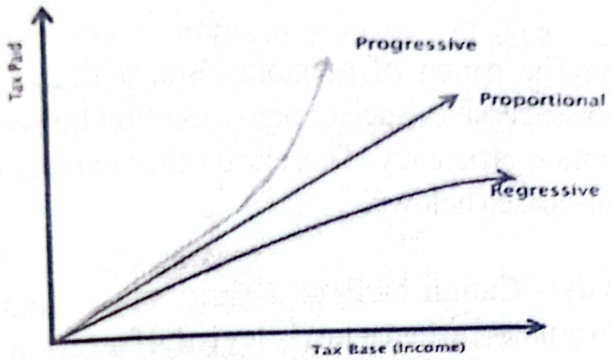


Figure 1: Proportional tax, Regressive tax and Progressive tax

i. Progressive Tax: the tax rate increases with income e.g. Pay-As-You-Earn (PAYE).
ii. Regressive Tax: the tax rate reduces as income increases e.g. Poll tax.
iii. Proportional/Neutral Tax: the same tax rate is imposed on tax payers irrespective of the level of income level.

Indirect Taxes

These are taxes levied on goods and services rather than on income of people or profits of company. Examples of indirect taxes are import duty, value added tax, excise duty, export duties, and purchase tax.

Principles/Canons of Taxation

This refers to the administrative aspects of a tax. It relates to the rate, amount, and method of levy and collection of a tax. This has to do with the characteristics or qualities which a good tax should possess. A good tax system should have proper combinations of all kinds of taxes having different principles/canons. According to Adam Smith, the four canons or maxims of taxation are: Canon of Equality or Equity; Canon of Transparent (Certainty); Canon of Economy and Canon of Convenience

1. **Canon of Equality or Equity:-** Taxation must ensure justice. The canon implies that the burden of taxation should be distributed equitably in relation to the ability of the tax

payers. Those who can afford to pay more should pay more. Equity or social justice demands that the rich people should bear a heavier burden of tax and the poor a lesser burden. Hence a tax system should contain a progressive tax rates based on the tax payer's ability to pay and sacrifice.

2. **Canon of Certainty:**-This canon implies thatthere should be certainty with regards to the amount which the taxpayer is requested to pay during the financial year. If the tax payer is definite and certain about the amount of the tax and its time of payment, he can adjust his income to his expenditure.

3. **Canon of Convenience:**-This canon implies thattax should be levied at the time and the manner which is most convenient for the tax payers to pay it e.g. property tax, house tax, income tax should be realised at a time when the tax payer is expected to receive income. The manner of payment of tax should also be convenient.

4. **Canon of Economy:**-The canon of economy states that the expenses for the collection of taxes should not be excessive. Such expenses should be kept as low as possible, and consistent with administration efficiency. There are other canons apart from the ones mentioned by Adam Smith is discussed below:

5. **Canon of Productivity:- Canon of Productivity** states that sufficient revenue should be produced for the government when a tax is levied. If a few taxes imposed yield a sufficient fund for the state, then they should be preferred over a large of taxes.

6. **Canon of Elasticity:- This canon of elasticity** states that the tax system should be fairly elastic so that if at any time the government is in need of fund, it should be able to increase its financial resources without incurring any additional cost of collection.

7. **Canon of Simplicity:-** The canon of simplicity states that the tax system should be fairly simple, plain and legible. It should not be complicated and difficult to understand.

8. **Canon of Diversity:-** Canon of diversity states that the system of taxation should include a large number of taxes which are economical. The implementation of variety of taxes is desirous from the point of view of equity yield and stability.

Reasons for the Imposition of Taxes

Tax is a major source of government revenue.

1. Through tax, government is able to meet its social, economic and political obligations such as building schools, building of hospitals, constructing roads and bridges.
2. Tax could be used to stimulate economic growth and development in an economy. Tax policies such as tax concessions, tax holidays could be pursued to aid rapid industrialisation.
3. Tax could be used to redistribute income in a society through Pay AsYou Earn (PAYE) system of taxation, where a high tax burden is imposed on the high income earners and proceeds used by government to provide subsidies for goods normally consumed by the low income earners.

4. It could be used to discourage the consumption of goods that may be harmful to health and social well-being of the people or discourage the consumption of ostentation goods.
5. Tax could also be used to control inflation and meet other social and economic policies of the government.
6. Taxes are used to protect infant industries so that they are able to compete favourably with foreign established industries.

Public Expenditure

Public expenditure also known as government expenditure refers to expenses incurred by public authorities such as central, state and local governments for their own maintenance and for discharging their duties towards the economy and society as a whole. Generally, public expenditure is usually higher than the revenue collected through various sources. The deficit is made possible through public debts. Public expenditure tends to increase with time. As the size of activities of government increase, government expenditure also increase. There are different ways of classifying public expenditure. It could be classified into capital expenditure and recurrent expenditure; exhaustive and non-exhaustive expenditure; and functional expenditure.

Classification of Public Expenditure

Capital Expenditure and Recurrent Expenditure

Public expenditure can be classified as capital expenditure and recurrent expenditure.

Capital expenditure includes all investment in infrastructural projects, physical assets that are for long-term purposes mainly to improve the living conditions of the citizens. This includes expenditure on sectoral development, housing, roads construction, railways, airports, seaports, and agriculture and water resources. They are generally productive investment. **Recurrent expenditure** is spending on services to maintain the existing facilities in the economy such as wages and salaries, maintenance of social services, security and subsidies.

Exhaustive and Non-Exhaustive Expenditure

Public expenditure can be classified into exhaustive and non-exhaustive expenditure. **Exhaustive expenditure** or spending entails the public sector directly buying goods and services such as medical equipment or construction of roads and bridges or paying the police or paramilitary. Thus, it is the public sector that determines the allocation of resources. On the other hand, the government does not determine the allocation of resources in **non-exhaustive expenditure**, rather, it is the firms and people who receive the financial support that makes their decisions through their purchases.

Functional classification of Public Expenditure

Public expenditure can also be classified on the basis of functions for which they are incurred. Government performs different functions such as defence, infrastructure, agriculture, social services and industrial development.

Canon of Public Expenditure

The following 8 canons of public expenditure were based on Prof Findlay Shirras public expenditure as shared by Moheeth (n.d.).

i. The canon of maximum social benefits is the most fundamental canon of public expenditure. The canon of social maximum advantage states that public fund should be expended to promote social maximum advantage (SMA) in the community. This implies that public expenditure should lead to maximum social advantage and welfare of the community or society as a whole and not to benefit a particular group of people.

ii. Canon of economy simply states that the available resources of a country should be used in a productive way to avoid waste and extravagance. Duplication of expenditure and overlapping of authorities should be avoided.

iii. Canon of productivity means that public expenditure should always be directed towards enhancing productive capacity of the economy in order to increase the level of production, demand, employment and maximise the national income.

iv. Canon of neutrality specifies that public expenditure should have a positive impact and not a negative impact on production, distribution and the economy. That is, public spending should lead to increase in production, increase in the level of economic activities and increase in wealth creation of the nation, while it should also lead to a reduction in income inequality.

v. Canon of equitable distribution states that the expenditure pattern of government should be so designed to benefit the poorer sections of the community. Public expenditure should be incurred in such a way that it should help reduce income inequality in the society or economy.

vi. Canon of sanction requires that there should be accountability on the part of government officials vested with the power to spend money so as to prevent extravagant spending and that money must be expended judiciously for the purpose for which it is meant after obtaining due approval or sanction from the appropriate authorities.

vii. Canon of elasticity implies that there should be flexibility in public expenditure based on prevailing circumstances and needs in the economy. For instance, it should be possible for government to increase public spending during emergency or economic depression and reduce spending when the economy is overheated or normal.

viii. Canon of surplus opines that government should prefer to have a surplus budget to a deficit budget, although, the latter is inevitable sometimes. As much as it is possible, government should ensure that revenue generated exceeds its expenditure so that the surplus generated can be utilised whenever there is deficit.

Theories of Public Expenditure

The following theories of public expenditure growth are discussed: Wagner law, Rostow-Musgrave and Peacock –Wiseman.

Wagner's Law

Also known as the law of increasing state spending. Wagner's law of increasing state expenditure states that the size of government as measured by public spending increases proportionally more than the growth of national income overtime. It opines that public expenditure increases constantly as income grows due to three main factors namely; Firstly, state social functions grow overtime, hence, there is the need for government to spend more spending by the state on environmental protection programme, retirement insurance, natural

disaster aid and so on. Secondly, the need to promote growth and development engender state spending on science and technology, which increases expenditure overtime. Thirdly, historically state resort to obtaining loans to meet contingencies. Thus, the debts and interest on the loans grows overtime (debt service expenditure).

Rostow-Musgrave Model

Rostow-Musgrave Model opines that due to the exigencies of promoting economic growth and development, the government usually embark on infrastructural development. Infrastructural facilities is believed would launched the economy from the primitive or traditional stage to take-off stage of economic development. Thus, as government is providing these infrastructural facilities, it's spending increases in order to develop an egalitarian society.

Peacock–Wiseman's Hypothesis/Model

This relates public expenditure to social political perspectives. It opines that public expenditure increases as income or revenue increases because political leaders would want to fulfil their electoral promises to the electorate so that they would be re-elected into office. Even though, some citizens may refuse to pay tax, which may lead to loss of revenue resulting in low revenue yield; the government will nevertheless bear the cost of governance by providing the needed social amenities to the society hence, government expenditure increases rapidly.

Review Questions (Essay)

1. What are the functions of public finance?
2. Why the imposition of taxes?

CBT Questions

1. Which canon of public expenditure requires that there is accountability on the part of government officials?
   a. Canon of economy b. Canon of elasticity
   c. Canon of surplus d. Canon of sanction

2. Which is not a theory of public expenditure?
   a. Keynes theory of public expenditure b. Peacock –Wiseman model
   c. Wagner law d. Rostow-Musgrave model

3. Which is the most fundamental canon of public expenditure?
   a. Canon of productivity b. Canon of maximum social benefits
   c. Canon of neutrality d. Canon of Equitable distribution

4. Which is not an example of Indirect taxes?
   a. Value Added tax b. Excise duties
   c. Company Income tax d. Import duty

5. Who bears the greatest burden of sales tax on inelastic products?
   a. the producer b. the consumer c. the middlemen

6. Who bears the greatest burden of sales tax on elastic products?
   a. The middlemen b. The consumer c. The producer

7. The canon of taxation in which tax should be collected when best suited for tax payer is called
   a. Canon of equity
   b. Canon of convenience
   c. Canon of administration
   d. Canon of certainty

8. Which is not an example of direct taxes?
   a. Value Added tax
   b. Capital gains tax
   c. Company Income tax
   d. Personal Income tax

9. Which type of tax discourages incentives to work?
   a. Sales tax
   b. Value Added Tax
   c. Personal Income Tax
   d. Company Income Tax

10. __ is a situation where individuals takes advantage of loopholes in the regulation and therefore manipulates his economic situation accordingly to pay low tax

Answer: Tax Avoidance

11. Which canon of public expenditure states that expenditure pattern of government should be so designed to benefit the poorer sections of the community?
   a. Canon of economy
   b. Canon of elasticity
   c. Canon of equitable distribution
   d. Canon of maximum social advantage

12. Which of the following option is correct?
   a. Budget Deficit is Government Expenditure > Government Revenue
   b. Budget Surplus is Government Revenue > Government Expenditure
   c. Balanced Budget is Government Revenue = Government Expenditure
   d. All the options

13. The theory of public expenditure, which states that the size of government as measured by public spending increases proportionally more than the growth of national income is called
   a. Peacock –Wiseman model
   b. Wagner law
   c. Rostow-Musgrave model
   d. Keynes theory of public expenditure

14. The criminal procedures of manipulating the tax form or refusing to pay tax altogether is called:
   a. Tax Avoidance
   b. Tax Evasion
   c. Tax manipulation
   d. None of the options

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ABOUT THE BOOK

The Faculty of Social Sciences under the Deanship of Professor I.P Ifabiyi, being student-centered and results driven, observed a dearth of reading materials for students in specific courses and topics the implication of which include difficulty for students in preparing for examinations and continuous assessment with negative consequences for their performance. This situation cannot be adequately addressed by a long list of references in different courses alone because these references may not be handy during examinations. Thus there is a need for a painstaking selection of such courses and topics across departments in the Faculty with a view to preparing a compendium of reading materials on them. This approach is expected to yield better results because these materials were compiled from the submissions of the lecturers that have been teaching these courses and are familiar with the topics. Thus, students, through these materials will access the 'minds' and 'styles' of their lecturers first-hand. Thus, *'Social Sciences for Beginners'* is produced in three volumes covering a wide range of courses in all the departments in the faculty. Volume 1covers topics in Geography and Economics, Volume 2 covers topics in Sociology, Social Work, Criminology and Security Studies, Psychology and Political Science while Volume 3 covers topics in Elementary Social Statistics and Computer Appreciation. The topics in the three volumes were rendered in classroom languages and down to the level of the student. We the fervent believe that students will find solutions to a host of challenges in many courses and topics that may have menaced them over time. The lecturers will also find teaching even more convenient since course materials have been produced in advance and may also aid students' participation in class since they already have a fairly good idea of the topics through the social sciences for beginners series. The Book Project Committee expresses its appreciation to the Dean for the confidence reposed on us and our colleagues for the maximum cooperation extended.

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Chairman and Editor-in-Chief
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