TAXATION

3rd SEMESTER

TOPIC:

PRINCIPLES OF TAXATION IN INDIA

DR. J. VIJAY KUMAR

LECTURER IN COMMERCE

Principles of taxation

A tax system (that is, the set of all taxes) for achieving certain objectives chooses and adheres to certain principles which are termed its characteristics. A good tax system therefore, is one of which designed on the basis of an appropriate set of principles, such as equality and certainty. Mostly, however, objectives of taxation conflict with each other and a compromise is needed.

Therefore, usually economists select some important objectives and work out the corresponding principles which the tax system should adhere to. The first set of such principles was enunciated by Adam smith (which he called Cannons of Taxation)

Canons of Taxation

The four canons of taxation as prescribed by Adam Smith are the following:

(1) Canon of Equality

This canon proclaims that a good tax is that which is based on the principle of equality. In other words subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion of their respective abilities, that is, in proportion to the reserve which they respectively enjoy under the protection of the State. It implies what the income which a person enjoys under the protection of the State, should be taxed on the proportional rate of taxation.

But modern economists do not agree with Adam Smith. They advocate progressive taxation to observe the canon of equality. In other words, they advocate progression should be the basis for imposing taxes.

(2) Canon of Certainty

This canon is meant to protect the tax payers from unnecessary harassment by the 'tax officials'. It implies that the tax-payer should be well informed about the time, amount and the method of tax payment. According to Adam Smith, "the tax, which each individual is bound to pay, ought to be certain and not arbitrary.

The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor and to every other person." Adam Smith was also of the view that the government must also be certain of the amount which it derives from a particular tax. Thus this canon is equally important both for the individual and the state.

(3) Canon of Convenience

The third canon of Adam Smith is that of convenience. According to Adam Smith, "every tax ought to be so levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it."

In other words, taxes should be imposed in such a manner and at the time which is most convenient for the tax-payer, i.e., the best time for the collection of land revenue is the time of harvest. Similarly, taxes on rent of houses should be collected when it is most convenient for the contributor to pay.

(4) Canon of Economy

The fourth canon is the canon of economy. This canon implies that the administrative cost of tax collection should be minimum, i.e., the difference between the money, which comes out of the pockets of people and that which is deposited in the public treasury, should be as small as possible.

Administrative cost of tax collection should be minimum because levying of a tax may require a great number of officers, whose salaries may eat up the greater part of the produce of the tax, and whose pre-requisites may impose another additional tax upon the people. Hence, the administrative cost should be minimum.

In addition to the above four canons given by Adam smith, the following other canons have been advanced by Basable and other economists

(5) Canon of Productivity

The canon of productivity advocated by Bastable implies that taxes should be productive.

The productivity of a tax may be observed in two ways. In the first place, a tax should yield a satisfactory amount for the maintenance of a government. In other words, the tax should be such that it procures a considerable amount of revenue for the expenditure of the government, Secondly, the taxes should not obstruct and discourage production in the short as well as in the long run.

(6) Canon of Elasticity

Bastable also laid stress on the principle of elasticity.

The canon of elasticity implies that yields of taxes should be increased or decreased according to the needs of the government. The government may need funds to face natural calamities and other unforeseen contingencies. It may need funds to finance a war or for development purposes. The government resources can be raised quickly only when the system is elastic.

(7) Canon of Diversity

The canon of diversity put forward by Bastable implies that the tax system should be diverse in nature.

In other words, in a tax system, there should be all types of taxes so that everyone may be called upon to contribute something towards the revenues of the state. Thus, the governments should adopt multiple tax system.

(8) Canon of Simplicity

The canon of simplicity implies that a tax should easily be understood by the tax-payer, i.e., its nature its aims, time, of payment, method and basis of estimation should be easily followed by each tax-payer. In other words, the tax imposed on the tax-payers should be so simple that they are able to guess easily the aim of its imposition and they are not confronted with accounting, administrative or any other difficulties.

(9) Canon of Expediency

This canon implies that the possibilities of imposing a tax should be taken into account from different angles, i.e. its reaction upon the tax- payers.

Sometimes it is seen that tax may be desirable and may be productive and may have most of the characteristics of a good tax, yet the government may not find it expedient to impose it, for example, progressive agricultural income tax, but it has not been imposed. So far in the manner it should have been imposed.

EFFECTS OF TAXATION

Taxation these days is not used as means of raising revenues only, but it is an important instrument for achieving socio-economic objectives, such as, regulation of consumption and production, controlling booms and depression, promoting economic growth and removing inequalities of income. The economic effects of taxation may be good as well as bad. Therefore, the government should not keep only the revenue considerations in mind, but the economic effects of taxation should also be considered.

Thus, in this we will discuss the economic effects under the following three heads:

- Effects of taxation on production
- Effects of taxation on distribution
- Effects of taxation on stabilization

I) Effects of Taxation on capacity to Work, Save and Invest

a) Capacity to Work

Capacity to work depends on the health and efficiency possessed by the people.

Health is related to the level of consumption which is determined by the money income of the assessee. Imposition of higher tax reduces the purchasing power of the tax payer and his ability to obtain the necessaries, comforts and luxuries of life. This effect is most strongly felt by the poorer people. When the tax burden falls upon the poor, it curbs the consumption of necessaries and comforts which lowers the standard of living and thus efficiency and ability to work of poor people is adversely affected by taxation.

b) Capacity to Save

Capacity of the people to save depends on the tax policy followed by the government. Ability to save is adversely affected by taxation as taxes fall on income and savings depend on income. When income is reduced by taxation, savings automatically decline. Ability to save is affected adversely in the case of those who have a higher marginal propensity to save.

c) Capacity to Invest

Capacity to invest depends on the resources available for investment that is savings.

It is clear from the above discussion that savings are reduced by taxation. When ability to save is adversely affected by high taxes, ability to invest of those who take investment decisions is automatically reduced. These are the people having a high entrepreneurial ability. Such people are generally the people in the higher income group.

II) Effects of Taxation on the will to Work, Save, and Invest

a) Effects on the Will to Work

Will of the people to work depends on the nature of taxes. Each individual tax has its specific effects. However, some taxes by their very nature have the least or no bad effect on the willingness to work e.g., estate duty excess profit tax etc. Likewise, reasonable rates of income tax, sales tax, etc, have no bad effects on the desire of the people to work hard.

b) Effects on the Will to Save

Will of the people to save depends on the volume of income, volume of tax and the tax policy pursued by the government.

If a tax payee has limited income and is hardly sufficient to meet his/her day to day requirements it will be difficult for him to save anything.

c) Effects on the Will to Invest

Will of the people to invest depends on savings. If savings are taxed, nothing will be left with the people for investment purposes. To enhance the will of the people to invest, the government should devise such a tax policy which provides tax incentives to those who divert their savings towards investment. Investment also depends on the treatment of income from investment-under tax laws.

III) Effects of Taxation on the Composition and Pattern of Production

The effects of taxation on the consumption and pattern of production depend upon allocation of resources. When higher taxes are imposed on some industries, resources will shift from the high taxed industries to low taxed industries. Likewise, when a tax rebate is offered, it will encourage allocation of resources in favour of developing industries.

Similarly, there will be reallocation of resources from high taxed regions to the low taxed regions. High rate of tax on goods of harmful consumption has a beneficial impact as the production of these goods will be diverted to low-taxed essential goods. Taxes may thus change the pattern of production in an economy.

A high tax on the production of luxuries may improve the production of necessaries. Some taxes, however, have no effect on diversion of resources; example, taxes on windfall gains, high land values, monopoly profits and non-differential taxes such as income-tax, etc have no effect on consumption or pattern of production.

THANK YOU