

The income of the government through all the sources is called **public** income or **public revenue**. **Public** Receipts: Considering **public** income in wider sense, it includes all the incomes or receipts which a **public** authority may secure during any period of time. ...

✓ Main Sources of Public Revenue

Modern governments collect their revenue from a wide variety of sources. These are taxation, fees, special assessments, fines, prices and the earnings of public enterprises.

(i) **Taxation:** The main source of revenue for the State is taxation. All of us know that a 'tax' is a compulsory levy made by the government and collected from the people in order to defray the expenses of the government in the common interest of all. The government can impose various kinds of taxes and realise the revenue required. We are familiar with land tax, income tax, sales tax, etc. We shall read in greater detail about taxes and their classifications afterwards. It should be understood that the kinds of taxes, the quantum of taxes and the manner of collection of taxes have varied from time to time depending upon the nature of the government and society.

(ii) **Fees:** Another source of revenue for the government is the levy of fees from the public for specific purpose. A fee is a payment for the service rendered by the State. It is defined as "a payment to defray the cost of each recurring service undertaken by the government primarily in the public interest, but conferring a measurable special advantage on the

payer." Registration fee, Insurance fee, Court fee, Licence fee, etc., come under this category, where the government renders certain specific service to the people and collects an amount called 'fee'.

(iii) **Prices:** The government gets revenue by the sale of goods and services to the public for a price. Some writers do not make the distinction between a fee and price when charged by a government. Generally, *fees* are levied for a *service rendered* to the public, like the Court fee or Licence fee. *Prices* are charged for the *sale of goods* and rendering material kinds of service. For example, sale of post cards and envelopes in the post office, the cost of a railway ticket bought in the railway station or the price paid for the purchase of fertilizer manufactured by a government factory.

(iv) **Fines:** The government may realise revenue in the course of imposing 'fines' on the public for acts of negligence or dereliction of duty or for non-compliance of formalities as enjoined in the rules, regulations and Acts of the State in various spheres of activity. Fines imposed in the court of law or by any competent authority will be credited to the public treasury. In this context, it should be understood that fine should not be strictly considered as a source of revenue to the government. It is only incidental. The ultimate object of imposing fine is only a 'corrective measure' and not 'revenue realising measure'. However, the government gets revenue by way of fines.

(v) **Special Assessment:** The government may also realise revenue through 'special assessment'. This is also in the nature of a tax imposed on beneficiaries of certain type of special service or treatment, particularly in the case of benefits resulting to property owners. For example, if a 'park' is opened in an area, the adjoining house owners or real estate owners will reap certain benefits. The value of their property will increase and the rental values will also increase. It is but proper that these groups of people are asked to pay a 'special tax' for incurring the expenditure in maintaining the park. The imposition of this type of tax is called 'Special Assessment'. In England this is called 'betterment tax' and in India this is called 'betterment levy'.

Special assessment is made particularly when the capital value of the land is enhanced by the introduction of some projects in the nearby area. Irrigational levy is also a good example coming under this category. When the construction of an irrigation channel renders benefit to the land owners, they can be asked to pay a 'special levy'.

There are certain special features in the case of Special Assessment. They are:

- (a) It represents an exercise of taxing power by the State.
- (b) There should be an element of public purpose.
- (c) The benefit should be capable of apportioning for purposes of special levy.
- (d) It relates to only special local improvements where a group of people are the beneficiaries.
- (e) When it is levied, the government performs a definite particular act in return.

Considering all these points, special assessment can be defined as follows:

“Special assessment is a levy to defray the cost of a particular improvement and is theoretically in proportion to, but never in excess of, the resulting benefit accruing to the property against which it is levied.”

(vi) Earnings of public enterprises: The earnings of public sector enterprises are called ‘Commercial revenues’. These are the prices paid for government produced goods and services. Every efficiently run public sector undertaking is expected to contribute to the general revenues of the government out of their earnings.

Besides these, there are other minor sources of public revenue. They are Forfeitures, Escheat, Gifts and Grants. Forfeitures of bails of bonds refer to the penalties imposed by courts for the failure of individuals to appear in the courts, to complete contracts as stipulated, etc. Escheat refers to the claim of the government to the property of a person who dies without having any legal heir or without keeping a will. Thus, bank balances and other properties of such persons will pass on to government. Under the rights of escheat, the government may also acquire the unclaimed property of dissolved trusts. All these sources of income are very insignificant.

Besides these, the government may get gifts and grants from the patriotic minded people or organizations for specific purposes during times of war or natural calamities like cyclone, flood or earthquake, etc. These are not very significant in the modern revenue system.

Classification of Public Revenue

In modern financial literature, it is customary to deal with classification of public revenue. This helps us in studying the sources of public revenue in a scientific manner. But opinions differ on the subject of classification of public revenue. Prof. Seligman has remarked, “among

Definition of a Tax

"A tax is a compulsory contribution from the person to the State to defray the expenses incurred in the common interest of all without any reference to the special benefits conferred." So defines Prof. Seligman and almost all writers define the tax, more or less, in a similar manner.

Tausig defines the tax as

Objectives of Taxation:

The primary purpose of taxation is to raise revenue to meet huge public expenditure. Most governmental activities must be financed by taxation. But it is not the only goal. In other words, taxation policy has some non-revenue objectives.

Truly speaking, in the modern world, taxation is used as an instrument of economic policy. It affects the total volume of production, consumption, investment, choice of industrial location and techniques, balance of payments, distribution of income, etc.

Economic development of any country is largely conditioned by the growth of capital formation. It is said that capital formation is the kingpin of economic development. But LDCs usually suffer from the shortage of capital.

To overcome the scarcity of capital, governments of these countries mobilize resources so that a rapid capital accumulation takes place. To step up both public and private investment government has tax

Objective # 2. Full Employment:

Second objective is the full employment. Since the level of employment depends on effective demand, a country desirous of achieving the goal of full employment must cut down the rate of taxes.

Consequently, disposable income will rise and, hence, demand for goods and services will rise. Increased demand will stimulate investment leading to a rise in income and employment through the multiplier mechanism.

By raising the existing rate of taxes or by imposing new taxes, the process of capital formation can be made smooth. One of the important elements of economic development is the raising of savings- income ratio which can be effectively raised through taxation policy.

However, proper care has to be taken, regarding investment. If financial resources or investments are channelized in the unproductive sectors of the economy the economic development may be jeopardized, even if savings and investment rates are increased. Thus, the tax policy has to be employed in such a way that investment occurs in the productive sectors of the economy, including the infrastructural sectors.

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Objective # 4. Control of Cyclical Fluctuations:

Fourthly, control of cyclical fluctuations—periods of boom and depression—is considered to be another objective of taxation. During depression, taxes are lowered down while during boom taxes are increased so that cyclical fluctuations are tamed.

Objective # 5. Reduction of BOP Difficulties:

Fifthly, taxes like custom duties are also used to control imports of certain goods with the objective of reducing the intensity of balance of payments difficulties and encouraging domestic production of import substitutes.



Chapter 6

Canons of Taxation

Adam Smith's canons of taxation have become classical in any literature on Public Finance. Many practical British Ministers like Gladstone and Peel made fiscal reforms on the basis of Adam Smith's canons of taxation. Josiah Stamp has paid a glowing tribute to Adam Smith by saying that he had "performed noble service in economic thought and teaching for over hundred years." Let us discuss the canons of taxation as propounded by Adam Smith.

(i) Canon of Equality

The first canon of Adam Smith is the canon of equality. This is also called the 'ability to pay' principle on taxation. This means that taxation should be imposed on people according to their capacity to pay taxes. Poor persons whose income is low, should be taxed less and rich persons should be taxed more. This object of the canon connotes equal sacrifice on each tax payer. The basis of this principle is that all men are equal and each should contribute towards public expenditure in such a measure as is within the capacity. *This canon involves the principle of justice.* Adam Smith while enunciating this says, "The subject of every State ought to contribute towards the *support of the government*, as nearly as possible in proportion to their *respective abilities*, i.e., in proportion to the revenue which they respectively enjoy under the protection of the State."

Smith's first canon of taxation has become the very definition of a tax. In the definition, the expression *ought* emphasises the duty on the part of the citizens to pay taxes. *Support of government* signifies the political object of taxation. The expression *protection of the State* notifies the services rendered by the State to its people, and *ability to pay* indicates equitable sharing of the tax burden.

Considering all these, the first canon of taxation of Adam Smith is the canon based on Justice in equitable sharing of the cost of running the State. The other three canons are called 'administrative precepts'.



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(ii) Canon of Certainty. "The tax which each individual is bound to pay ought to be *certain* and not arbitrary which



(ii) Canon of Certainty

The Second canon is called the canon of Certainty. "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." The canon of certainty is ensured through the publicity of the budget and the discussions in the Parliament or Legislature on every detail of taxation. So, everyone comes to know certainly about the new taxes imposed and the rate of the taxes, etc.

But on a deeper analysis, we can find that Smith's canon of *Certainty* signifies something more than this. Not only should the tax payer know the tax to be paid; when to be paid, and how much to be paid, but also he should be *certain* about the rate of the tax for a fairly long period to take up investment decisions. Frequently tinkering with tax rates, changing the base and rates annually in the budget will create an air of *uncertainty* among the tax-payer. Supplementary budgets, mini-budgets, changing the structure of the taxes envisaged in the main budget will shake the confidence of the tax-payer.

(iii) Canon of Convenience

"Every tax ought to be levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it." The object of this canon is to reduce the psychic burden and the inconvenience of paying the tax. The income tax is usually collected at source; the sales tax is collected at the time of sale of the commodity, and the import duty is collected at the time of importing the goods into the country, so that payment might be convenient and less burdensome to the tax payer.

(iv) Canon of Economy

"Every tax ought to be so contrived as both to take out and keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the State." The canon of economy signifies that the cost of collecting the revenue should be kept at the minimum possible level. The process should not impair the productive powers of the community. The tax laws and procedures should be simple so that the people might easily understand them and might not have to incur a heavy expense to maintain their accounts and fill in the tax returns.

Of the four canons of taxation, the most important is the first one which is a *rule of taxation* and others are only *rules of administration*. Sometimes, it is very difficult for a tax to conform to the four principles. For instance, customs duty is a convenient tax, but it is neither equitable



Canons of Taxation

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nor economic. The income tax satisfies the canon of convenience. In cases of conflict, the more important canon must be our guide.

The above canons of taxation are considered as fundamental principles of taxation. But owing to the needs of the modern State and the problem involved in them, the canons of Adam Smith needs to be supplemented by certain rules, most of which should be treated as corollaries to the canons of taxation. The following additional principles may be added.

(a) Simplicity

A system of taxation should be simple, plain and intelligible to the common understanding of the tax payers. (The incidence and effect of tax should be easily traced.)

(b) Elasticity

The tax system should yield adequate revenue which should be capable of being adjusted to the annual needs of the State. Without making any major structural changes, the tax system should yield more revenue.

(c) Stability

Taxes should not be frequently changed. This will bring about an unsettled condition among the producers and would not give them time to adjust their programmes in the light of the tax policy of the State. This does not mean that the tax system should not be flexible. It should be stable, as well as flexible.)

(d) Equity

The most desirable characteristic feature of tax is that it should be fair. Two classes of equity are distinguished. The first one is *horizontal equity*. This refers to equal treatment of equal people. For example, people with equal incomes should be asked to pay the same amount of income tax. The second one is *vertical equity* which refers to the treatment of tax payers with unequal incomes with the appropriate degree of inequality in the rate structure. In modern days, this type of equity cannot be achieved in practice.

(e) Beneficial

Taxation should not interfere with the process of production in the economy. It should not take away the incentive to save, and should not adversely affect the capital formation.

(f) Neutrality

The tax imposed should avoid distorting the working of the market mechanism. An individual when he wants to buy a commodity is expected to institute a comparison of the benefits of his purchase with the

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cost involved. Any taxation which is related to any economic activity clearly distort this *comparison of costs and benefits*. The distortion which is involved in the process of taxation is known as the *excess burden of taxation*.

(g) Economic Efficiency

Kaldor holds the view that the principle aim of taxation is to increase private expenditure and the success of the tax should be judged from this angle. The expenditure restraining effect of tax is "economic

the base of taxes.

Direct and Indirect Taxes

According to Dalton, "A direct tax is one which is really paid by a person on whom it is imposed whereas an indirect tax, though imposed on a person, is partly or wholly paid by another." To put it more simply, a direct tax is a tax wherein the tax-payer and the tax-bearer are the same person. In the case of indirect taxes, the tax-payer and the tax-bearer are different persons.

This classification is based on the process of shifting the burden of the tax. In the case of direct tax, the impact and the incidence of the tax lie on the same point, *i.e.*, the burden of the tax cannot be shifted. In the case of indirect tax, the impact and incidence fall at different points or persons, *i.e.*, the burden of the tax can be shifted. A good example of a direct tax is *Income Tax* and a good example of an indirect tax is *Sales*

Tax. In the former, the tax-payer and the tax-bearer happened to be the same person, while in the case of latter, the tax-payer and the tax-bearer are different persons.

It is also stated that this classification is based on the intention of the legislature while imposing the tax. If the legislature intends that the burden of the tax should not be shifted and it should be borne by the payer himself, then it is a direct tax. If the legislature intends that the burden of the tax should be shifted, then it is an indirect tax.

De Marco makes this classification on the following grounds: "Direct taxes strike the citizens income at the moment of its production. Indirect taxes are those which strike the private consumption of citizens and also transfer of property. They strike the income at the moment when the citizen spends it to acquire other goods."

Another distinction is made by Mrs. Hicks. She writes: "The essence of the British distinction between the direct and indirect taxes lies in the relation between the tax-payer and the revenue authorities." If the taxes have to be calculated afresh in each case, necessarily there will be personal and direct relationship between the tax-payer and the tax-collector and this can be termed as direct taxes, e.g., Income-tax. In certain other cases, it is convenient for the revenue authorities to have the tax collected through the agency of manufacturers or merchants who are used as unofficial tax collectors. In these cases, there is no direct relationship between tax-payers and revenue authorities and the taxes so collected may be termed indirect taxes, e.g., Sales tax.

There is also wrong assumption in the classification that direct taxes are personal taxes and indirect taxes are commodity taxes. It is not so. Commodities do not pay taxes. In all cases of taxes, the payment is made only by persons.

Though there are lot of controversies regarding the basis of classification of direct and indirect taxes, both types of taxes are levied by the government.

The Merits and Advantages of Direct Tax

(i) The direct tax will be proportionate depending on the 'ability of the tax-payer to pay' and in this respect there will be equity in this type of tax. In the case of income tax, people with lesser income have to pay less tax and people with larger income have to pay more tax.

(ii) Direct taxes are collected at the source and it will be elastic and productive. Increased rate of the tax will bring larger revenue without much expenditure.

(iii) The possibilities of leakage will be very rare and the whole tax paid reaches the treasury of the State.

(iv) Above all, there is an element of certainty in the case of direct taxes. The payer knows the exact amount to be paid and the time of payment.

(v) It is possible to trace the effects of direct taxes very easily and if need be minimize the adverse effects only.

The Disadvantages of Direct Taxes

(i) Direct taxes have always been unpopular among the people. These taxes have been opposed some times with political disturbances.

(ii) This may lead to evasion by the tax-payers by making false declarations and maintaining two sets of accounts. This will undermine the morale of the people. 'A direct tax is a tax on honesty'. Whoever is honest would pay taxes by declaring the income properly. Those who are dishonest will be cheating the tax department by making false statement and concealing their incomes. The government in their turn will be announcing or sanctioning better benefits through 'Voluntary Disclosure Scheme' or through similar schemes, in order to unearth black money from these dishonest tax-payers or those who evade taxes.

(iii) In the collection of these taxes, there are more possibilities of arbitrary official action in making assessments of income of individuals. It may even go to the extent of official harassment. Of course, this type of disadvantage holds good in all types of taxes, in modern days, especially when the official machinery is very corrupt.

The Advantages of Indirect Taxes

(i) The first merit and advantage of an indirect tax is that it is convenient both to the tax-payer and the taxing authorities. The indirect taxes are less annoying to the people, as the tax-payers may not be knowing that they are paying taxes to the government in the form of increased prices. Indirect taxes are like sugar-coated pills in the form of higher selling prices. This will help the government in realising the revenue very easily without becoming unpopular, as in the case of direct taxes. The consumer of articles taxed will be paying in small instalments. The State will be able to collect the tax in a lump sum from the merchants, importers and exporters or producers, as the case may be. Hence, Colbert said that this is like 'plucking the goose with least squealing'.

(ii) Indirect taxes are difficult to evade.

(iii) It is only through indirect taxation the State can reach all classes of people and collect money for the coffers of the State. State cannot levy direct taxes, like income tax, to poor people in general.

(iv) Further, this tax will quieten the agitation on the part of rich people who might complain that they are the only people contributing to the running of the State. Through indirect taxes, these rich people may derive some emotional satisfaction that other classes of people are also made to pay towards the the upkeep of the State.

(v) An indirect tax may be effectively used in restructuring the consumption pattern of the society. It may check consumption of harmful articles like liquor, cigarettes, etc. By heavily taxing these harmful articles, the government may divert the purchasing power towards the purchase of useful articles and thereby create beneficial consumption pattern.

The Disadvantages of Indirect Taxes

(i) The first criticism against an indirect tax is that it may not be equitable. Taxes on essential commodities is an unjust levy and it will fall heavily on the poor people.

(ii) The yield from indirect taxes will be always uncertain. The yield depends on the elasticity of demand for the taxed commodity. If the government wants to be certain of revenue, it must tax the necessary commodities at a fairly high rate, as these commodities will have inelastic demand. But, such a measure would create adverse effect on the economy. It may affect the ability to work and save on the part of low-income classes.

(iii) Indirect taxes may prove uneconomical at times. The cost of collection of these taxes would be very heavy. The State has to maintain a large army of officials to check evasion of these taxes and to collect the taxes properly.

Thus there are many advantages and disadvantages in both the types of taxes.

Chapter II

Income Tax

In this chapter and in the succeeding chapters, we shall study in detail about the various types of taxes. These taxes can be classified into various categories, viz., Taxation of Income and expenditure; Taxation of Capital; Commodity taxation; and Agricultural taxation.

Under taxation of income, we have to study –

(i) Personal Income-tax; (ii) Corporation tax; (iii) Capital Gains tax; and (iv) Excess profit tax.

(i) Personal Income-Tax

Income-tax is a perfect example of a direct tax. It is a tax on the income of the tax-payer, whether an individual or a corporation. In addition to this tax, most of the States levy a 'surcharge' on the income-tax. It is also usual to enhance the rates, when the income is over a high minimum and it goes under the name of "Super-tax" which is levied in addition to the income-tax.

The income-tax affects not only the residents, but also the non-residents who may derive their income from a source within the country. It is *source of income* and not the residence of the income receiver that determines the tax liability.

The Concept of personal income: There are two ways of defining income for determining tax liability. The first is a *flow concept* and the second is the *accrual concept*. The two concepts produce different results, when applied to the problems determining personal tax liability under the income-tax.

The fundamental difference between the two lies in the treatment of the increased value of capital assets owned by individuals, in the treatment of income saved, and in the treatment of gifts and bequests. The flow concept has usually led to more of an insistence upon realization as a test of income as compared to second concept which rests upon accrual.

Categories of Income taxed

At present incomes are classified under six heads or categories for purposes of income taxation: (a) Salaries; (b) Interest on securities; (c) Income from property; (d) Profits and gains of business, profession or vocation; (e) Income from other sources which also includes dividends; (f) Capital gains.

The classification in the above categories is meant only to prescribe the rules applicable for the computation of taxable income of each particular category and not for the purpose of fixing the tax-rate on each type of income. Taxable income from all sources is to be reported on a single return and only one assessment is made of income under all categories. *The income-tax is levied on net income and not on the total income.*

Taxable income of an individual

Various kinds of exemptions and deductions are made from the gross income of the individual, in order to arrive at the net taxable income. For example, income below a minimum level is generally exempted. Life insurance premia paid by an assessee on policies of his own life or on that of his wife have been exempted in India, subject to certain conditions. Exemptions and deductions are made in the case of (i) income of certain public, religious and charitable institutions; (ii) income from co-operative societies; (iii) agricultural income upto a certain limit; (iv) amount of life insurance paid; (v) amount of deposit in PF account; (vi) yield of post-office cash certificates, etc. The purpose of these exemptions and deductions is for encouraging some social objectives.

Arguments For and Against Income-tax

Income-tax belongs to the family of direct taxes and it claims to have certain merits. It satisfies almost all the canons of taxation.

1. It satisfies the canon of *Equity*. It is the first ground on which income-tax is supported by economists. The burden of the tax can be distributed among the tax-payers according to their ability to pay, in the case of income-tax.

2. There is *distributive justice* in this taxation. If the rates of income-tax are progressive, they can reduce inequalities of income distribution, as progressive income-tax falls heavily on higher income groups and lightly on lower income groups. It therefore reduces the disposable income of the rich and the gap between high income and low income.

3. This tax can *check concentration of economic power*. The concentration of power in the hands of a few is a social, economic and

political evil. Progressive income-tax measures ensure that the rich will not go on accumulating income. A major portion of their income can be taken away by the government in the form of income-tax. Thus, the concentration of national income in the hands of a few can be prevented.

4. Income-tax ensures *revenue productivity*. In the case of progressive income-tax, the rate goes on increasing with every increase in income. In a developing economy, where the income of the people rises because of an increase in public expenditure on different projects, this merit of income-tax is of great importance. There is a built-in flexibility in income-tax, because of which ever increasing public expenditure can be met.

5. *Economic stability* is another advantage arising out of this type of tax. Income-tax can act as a counter-cyclical measure, thereby protecting the economy from the evils of inflationary spiral and deflationary pressures. When there is a need for reducing the disposable income and effective demand or increasing disposable income and effective demand, the progressive income-tax can help to a great extent.

6. *Control of consumption* is another merit of income-tax. In an underdeveloped country, the propensity to consume is very high and when the income increases due to planning, the people will not resort to savings of increased income. On the contrary, they will consume more. The income taxation can help in taking away sizable part of their income and reduce their consumption. Conspicuous consumption by the rich could be prevented by means of progressive taxation.

7. This tax is very *convenient* and also *economical*. Income-tax is convenient to pay and collect. Every one knows the exact amount he has to pay towards income-tax and therefore, he can make arrangements to pay the tax without disturbing his own budget. The government may also know accurately the revenue realisation consequent on the imposition of the tax. Since these taxes are collected at the source, no inconvenience is involved in collection. This is economical, as the administrative expenditure will be least and it will not rise much with the increase in the tax-rate.

Arguments against Income-tax (Demerits of the tax)

In spite of its merits, income-tax is criticised on several grounds:

1. *How to measure the personal income?* In order to make an assessment of the tax, the personal income of the individual has to be calculated. This is a very difficult task. In an underdeveloped country where majority of the people are uneducated, and illiterate, they do not maintain proper accounts. The farmers in the rural areas do not keep

accounts or a record of their transactions in the market. Petty shopkeepers, artisans and sole-trading concerns rarely keep records of their income. Further, in a country like India, the non-monetized sector is large and transactions in the non-monetized sector cannot be brought under the income-tax accounting. So, estimation of personal income may not be accurate and there is lot of scope for arbitrary assessments, leading to harassment of the tax-payer.

2. There is *scope for inequity in taxation*. Though, theoretically, the burden of income-tax is borne on the basis of the individual's 'ability to pay', in practice, it may not be so. Since the income of the person cannot be estimated exactly, there is bound to be over-estimation of the income of the individual. Taxation may become arbitrary in nature, and instead of equity, it may lead to injustice in taxation.

3. *Tax evasion* of income-tax is fairly widespread among all classes of people, particularly very rich people. Since the tax-payers know that their disposable income is reduced by the payment of tax, they are tempted to evade it. They would try to evade the tax by giving false information about their income.

Because of large scale tax evasion, the revenue productivity of income-tax would be considerably reduced. In all countries, the actual revenue yield from income-tax is much less than the potential revenue yield. In order to check evasion, the government has to maintain a large machinery which would increase the administrative expenses in collecting the taxes. Thus, higher revenue productivity under income-tax is only a myth.

4. According to J.S. Mill, the levy of income-tax often results in *double taxation of savings*. The tax is collected when the income is earned and again when the saved income earns interest. Pigou holds the same view. This double taxation of savings discourages people to save. This would ultimately, reduce investments in the economy and result in reduction in National income.

Effects of Income-tax

1. It is argued that the *income-tax discourages work effort* as it reduces the reward for work earned by the people. The people may find it profitable to substitute 'leisure' for work. The more progressive the income-tax the more powerful this substitution effect will be, as the tax reduces the desire to work. Though this argument is acceptable, it is not totally correct. When the disposable income is reduced by means of taxation, the people would try to work more and earn more. When the demand for income is inelastic, the tax-payer would work more and earn more in order to maintain his original level of income.

2. *Effect of Risk-taking* : It is argued that income-tax reduces the income of the people and as such it affects adversely risk-taking by investors. Since, a substantial portion of the income is sliced off due to progressive taxation, the reward for taking risk is reduced and the tax will act as disincentive to taking risks. The counter argument is that income-tax would induce the investors to invest more on high-yielding assets and take greater risk, as the income-tax reduces the income of the people. For those who are in need of money, this tax will give temptation to invest more. Again, these two controversial points can be met only by the attitude and psychology of the tax-payer and also his demand elasticity for money income.

3. *Reduces savings* : As indicated already, income-tax is a double taxation of savings and it dampens the desire to work and save. If the tax-payer is interested in saving a fixed amount, including the interest, every month, the levy of income-tax does not discourage their savings. In these cases, savings may be made to provide for the future, like old age, sickness, education and marriage of children, etc.

4. As stated already, the most serious adverse effect of income-tax is *reduction of the level of national income*. Since the income of the rich people would be reduced in larger amount due to progressive taxation, the desire of the rich to work, save and invest, would get reduced and this would ultimately result in the decline of national income.

5. *Effect of occupational distribution* : The income-tax will affect the occupational distribution, as it is easy to evade this tax in certain occupations. As a result, the flow of population may be into such occupations where the non-monetary benefits are large and the burden of income-tax is felt very lightly. In the case of salaried class who have a record of their salary maintained by employers cannot evade tax payment.

production. Moreover, the economy as a whole should grow fast.

SALES TAX

The term Sales Tax or turnover tax may refer to a general tax on all sales or only on particular commodities. Taxes imposed upon sellers or buyers of products, when the basis of the tax is the amount of sales (or purchase), can be termed "Sales taxes". It is a tax levied on all sales of commodities. It is imposed on the basis of the price of a commodity and falls on sellers as well as buyers. Sales tax can be levied in different forms as a turnover tax, as a single point tax or as a multiple sales tax.

Varieties of sales tax : (i) *Sales tax or turnover tax*: When the tax is imposed on sales of goods, it is known as sales tax. But, when the tax is on the sale of goods as well as services, it is known as the turnover tax.

(ii) *General Sales tax or selected commodity tax* : When a sales tax is levied on all goods without discrimination, it is termed as general sales tax. When it is levied on some selected commodities, it can be termed as selected sales tax.

(iii) *Retail or wholesale tax* : When it is levied on all transactions, it is called retail tax. When it is levied on wholesale transactions, it is called wholesale tax.

(iv) *Single or Multiple sales tax* : When the sales is imposed only at one stage, whether it is wholesale or retail stage, it is known as a single-point sales tax. When it is imposed on all stages of the sale of a commodity, it is known as the multiple point sales tax. In a single point sales tax, the tax is to be paid only once. But in the multiple point variety, it has to be paid every time the sale is made, with the result the effect is cumulative, or it has got a 'snow-ball' effect.

Merits of sales tax

The Sales tax belongs to the family of indirect taxes and has many valuable merits. It is recommended on the following grounds:

(i) *Revenue Productivity and Certainty* : The revenue from sales tax has been very productive. This tax will not fluctuate like the income-tax. The tax is more or less on consumption and the level of consumption of people is more stable and consequently the realisation from sales tax would be fairly stable. Certainty of collection is another virtue of this tax. How much is collected will depend upon the volume of sales which, in turn is determined by the volume of consumption.

(ii) *Low cost of administration* : Sales tax more or less collects itself. It is collected by traders and producers on behalf of the government which, therefore, does not have to spend anything to collect it. Also, there is an inverse relationship between the cost of collection and the tax rate. The higher the tax rate, the lower the cost of collecting it. Perhaps, this will be a temptation for the government to keep the rate of tax on the high side.

(iii) *Compensatory effect* : The sales tax has a compensatory effect. It is regressive in its incidence. Income-tax which is progressive in nature, falls heavily on the rich; the sales tax falls heavily on the poor. The progressive and regressive effect of the tax system are thus balanced for the different sections of the community.

(iv) *Elasticity* : This tax satisfies the canon of elasticity. The government can collect additional revenue by casting its net over a wide variety of products and by varying the rates of sales tax. Since the

consumer does not feel the burden of this tax, he will not have any objection to pay more, if there is any increase in the rates of the tax. Any increase in this tax will go unnoticed by the consumers and yield more revenue to the government without creating any political unrest. Tax evasion will not be a problem.

(v) *Check on consumption* : Sales tax can be used as an instrument to check consumption. When prices go up because of the imposition of the sales tax, they act as a disincentive to consume more. A sales tax can be used to curtail the consumption of luxury goods and prevent conspicuous consumption. In developing countries, this tax can be used to reduce the consumption of essential goods in times of scarcity.

(vi) *Promotion of tax consciousness* : Sales tax creates a healthy tax consciousness in the minds of the public, which will have a salutary effect of making them take a more active interest in public affairs. Of course, this argument is not exclusive to sales tax, and it can be applied to any tax.

Demerits of sales tax

Sales tax is strongly criticised by a number of economists. Seligman remarks "The general tax constitutes the last resort of countries which find themselves in such fiscal difficulties that they must subordinate all other principles of taxation to that of adequacy."

(i) *Low revenue yield* : According to Seligman "the revenue from the Sales tax is woefully inadequate." This happens because of the wide tax evasion.

It cannot be taken for granted that a rise in the rate of the tax will correspondingly bring more revenue. The sales tax is no respecter of the rules of arithmetic, in the matter of yield.

(ii) *Question of payment* : Seligman also pointed out that the question of who will pay the tax cannot be settled easily. If the tax is paid by the purchaser, it will amount to a tax on expenditure. This will invert the principle of 'ability to pay'. If the tax is paid by the sellers, the effect of the tax will be cumulative, and the price of the commodity will in the end be raised by much more than the original rate of the tax.

(iii) *Lack of Equality* : Sales tax is regressive in nature, and it cannot lead to an equal distribution of its burden. It ultimately falls on consumption, particularly on the necessities of life. This leads to injustice in taxation. Seligman was extremely critical of sales tax and endorsed the view that the sales tax is "a sort of inverted income-tax."

John F. Due, in his book "Sales Tax" gave the following reasons to show that, in practice, Sales tax will be iniquitous.

(a) This tax is not universal, and those who consume only essential goods need not bear any burden at all. (b) The shifting of the tax is not likely to be complete or exact. (c) The Sales tax may result in wage increase, which may push up the cost of commodities consumed by the poor.

(iv) *Tax evasion* : In every country, the sales tax is evaded on a very large scale. It can be evaded by purchasing smuggled goods or by purchasing the non-taxable articles. It also can be evaded by corrupting the tax authorities.

Problems of sales tax

In the working of sales tax in India for the past many years, several difficulties have been encountered by the traders and consumers. Several people made representation of their difficulties before the Taxation Enquiry Commission (1953) and their difficulties are even represented today in one form or other. Some suggestions have been put forward in this connection:

1. *Selective Sales Tax* : It has been argued that the bulk of the receipts from the sales tax is derived only from a few important articles. So, it is suggested that the imposition of sales tax should be selective, so that the traders affected will be minimal and the tax administration can also be streamlined in a better way. But the Taxation Enquiry Commission has pointed out that a general sales tax covering a number of articles is to be preferred.

2. *Single point tax* : Under single point system a specific amount of tax is added to the price at which the articles are sold to the consumer. It is collected at one point of sale, at the wholesale level or at the retail level. Generally, the single point sales tax is imposed on importers or producers. They pay the sales tax to the government and charge the same from their customers. Under the single point system, the tax rate is relatively high, and therefore, a number of articles, especially the more essential ones are usually exempted from the tax.

3. A *Multi-point sales tax* is levied at all stages of sales of a commodity. It is levied when the producer sells it to the retailer, and finally again, when the retailer sells it to the consumer. The rate is relatively low and the exemptions few. It can be charged from the consumers and, therefore, it is generally paid by them.

MULTI-POINT Vs. SINGLE-POINT SALES TAX

Chapter 8

Incidence of Taxation & Burden Shifting

When a tax is imposed by the authorities, the payer of the tax need not bear the burden of the tax. He may shift the burden of the tax on someone else. Hence, it is necessary to know who bears the immediate burden of the tax and who bears the ultimate burden of the tax. The problem of determining the ultimate burden of tax is the problem of determining the incidence of tax. In this connection, we meet with some terms which have to be understood in detail.

Incidence of a Tax

The term *incidence of tax* is applied to the ultimate resting place of the tax upon an individual or class of persons who cannot pass on the burden of the tax further. It actually decides the problem of who bears the money burden of a tax ultimately. For example, a tax on petrol will be passed on to service stations which pass on the burden to car owners and taxi owners. In their turn, the taxi owners may pass on the burden to the users of taxi in the form of increased taxi fare.

Impact of a Tax

An *Impact of a tax* refers to the question of who pays the tax *in the first instance*. The impact of import duty will be on the merchant importing the commodity. But the merchant will shift the burden to retailers and the shopkeepers in their turn will shift the burden to the consumers of the imported commodity.

Shifting is a process by which a tax is passed from one person to another. The shifting of burden could be done in the form of increased prices of commodities and services. The wholesaler by increasing the price may shift the burden to consumers. This is *forward shifting*. Or the original tax payer, may reduce the price for purchase of raw materials and other connected prices and shift the tax backwards to producers of raw materials. This is *backward shifting* of the burden of the tax.

Thus, in public finance relating to taxes, the expression 'incidence' refers to final resting place of the tax where the burden of the tax is borne. 'Impact' refers to the original collecting agent who pays the tax to the government as in the case of sugar, petrol, etc.

R.A. Musgrave points out that "the concept of incidence as the ultimate burden of a tax starts from the false premise that a tax always has an ultimate burden which is not the case."

Sometimes a distinction is drawn between '*formal incidence*' and '*effective incidence*'. By '*formal incidence*' is meant the money burden of taxes as resting with the subject on whom the burden is intended by the taxing authority to fall. For example, it may be assumed that the incidence of direct taxes rests with those who initially pay the tax. By '*effective incidence*', we mean the real or final distribution of tax burden after its shifting, in consequence of changing demand and supply conditions of the taxed commodity or service.

Pressure of Taxation

When the price of a commodity is increased by the tax amount, the tax is completely shifted. Though the consumer bears the entire burden, the tax pressure will have its reactions on the seller in the form of decreased sales and lesser profit. In this respect, the pressure of tax will be felt on all sides.

THEORIES OF TAX SHIFTING

We know that shifting of a tax refers to the process by which the money burden of a tax is transferred from one person to another. Whenever there is shifting of taxation, the tax may be shifted forward or backward. Thus, a tax imposed upon the producer may be shifted forward to the consumer; or a seller may shift the tax to the producer.

There are a few theories regarding the shifting of the tax burden. The main problem is the problem of who pays the tax in the final analysis, and how it is done. The theory of shifting owes much of its development to Adam Smith and Ricardo who treated taxation in relation to the problem of value and distribution.