Unit II

Public Finance

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Semester VI

Q. 1. Sources of Public Revenue

9 PUBLIC REVENUE–TAXATION

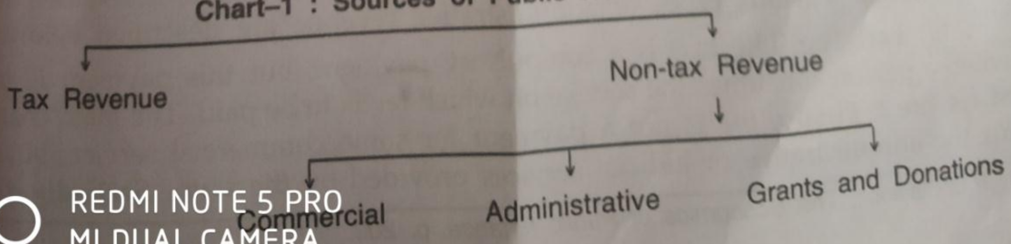
1. PUBLIC REVENUE–VARIOUS SOURCES

Modern governments require large amounts of resources to meet public expenditure. The resources constitute public revenue. Various sources of public revenue or income of the government are :

(i) Tax ;
(ii) Price ;
(iii) Fees ;
(iv) Income from government property ;
(v) Fines and punishment ;
(vi) Gifts and grants ;
(vii) Voluntary loans ;
(viii) Forced loans ;
(ix) Income from public enterprises ;
(x) Income from note-issue (currency) ;
(xi) Special assessment.

Various sources of public revenue can be broadly summed up under two heads: Tax revenue and non-tax revenue. Non-tax revenue sources again are sub-divided into three categories (a) commerical revenue, (b) administrative revenue and (c) grants and gifts.

Chart–1 : Sources of Public Revenue



1. Tax Revenue source. Taxation is the main source of public revenue in every country. Tax is a compulsory payment from the tax payer to the government. It has no relationship to any specific service rendered by the government to the tax payer. The revenue from taxation is used for the general needs of the government.

2. Non-Tax Revenue Sources. The tax revenue source remained the single major source and had the most important place in the financial structure of all the countries before the World War II. This was due to two reasons : (*a*) The government had little functions to perform and so it never bothered about other sources of public revenue. (*b*) The government interference in the economic life of the people was negligible and the government never took industry and trade into its own hands.

After World War II, the situation has changed radically and the importance of non-tax revenue sources have been increasing due to the following reasons :

(*a*) The functions of every government have increased and it requires greater revenue to fulfil its obligations.

(*b*) Non-tax sources of revenue are elastic. The government can obtain as much income as it likes from these sources. Taxation would yield only limited revenue.

(*c*) Non-tax sources of revenue do not adversely affect production and saving, whereas taxation beyond a certain limit reduces savings and hampers production.

(*d*) The government can regulate and control the economy in a better manner with the help of non-tax sources of revenue.

The three categories of non-tax sources of revenue are described below :

(*i*) **Commercial Revenue.** Commercial revenue is the revenue from the government enterprises. According to **Taylor,** *"The prices which we call 'commercial' are received in the form of prices paid for government produced commodities and services. They include payment for postage, tolls, interest on funds borrowed from government credit corporations, tuition to public educational institutions, prices paid for liquor in government stores, surplus war materials, electricity distributed by publically owned utilities and the like."* [1]

The main features of the commercial revenue are : (*a*) The price paid to the government is not a compulsory payment. It is paid only when one purchases a commodity. (*b*) There exists the quid pro quo relationship in price. The amount paid is adjusted to cost or benefit.

(*ii*) **Administrative Revenue.** Administrative revenue refers to the payment by the public for various types of administrative services rendered by the government. Administrative revenue includes fees, licence fee, fines, forfeitures, escheats and special assessments. Various types of administrative revenue are described below :

(*a*) **Fee.** Fee, like tax, is a compulsory payment, but this payment is made only when a person consumes the service on which fee is to be paid. The main characteristics of fee are : **Firstly,** fee is not a payment for some commercial service, but it is paid for administrative or judicial services provided by the state. **Secondly,** there is an

1. P.E. Taylor : *The Economics of Public Finance*, p. 200

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element of quid pro quo in a fee and the government adjusts the amount of fee according to the cost or benefit provided by it in the form of services. **Thirdly,** the payment of fee is compulsory.

(*b*) **Licence Fee .** Licence fee is paid not for any direct service provided to the payer, but only for the grant of permission. For example, one has to pay some fee to get permission to import some commodity. The motive of levying a licence fee is regulation and control over various types of activities.

(*c*) **Fines.** Fines are imposed on the law-breakers so that they may not break the law again.

(*d*) **Escheats.** In cases when a person neither makes any will nor does he leave any heir, the government becomes the owner of his property.

(*e*) **Special Assessment.** Special Assessment is a type of tax which is not levied on every one but is collected from those persons whose property has increased in value due to certain improvemental works of the government.

(*iv*) **Grants and Gifts.** Grants are given by one government to some other government in the same country (*e.g.*, central government to state government) or by one country to another country. Gifts and donations are given voluntarily and the donars do not receive any direct benefit by giving donations. Besides, there are different types of loans (internal and international, voluntary and forced, and so on) through which the government can raise funds.

2. TAX Q.2 (a) Taxation – meaning

Tax, which is the largest source of public revenue, is a compulsory payment to the government by the tax payer without any expectation of any specific return. Economists have defined tax differently. In the words of Dalton, "A tax is a compulsory contribution imposed on public authority, irrespective of the exact amount of service rendered to the tax payer in return and not imposed as a penalty for any legal offence." Seligman defines a tax as "a compulsory contribution from a person to the government to defray the expenses incurred in the common interest of all, without reference to specific benefit conferred." According to Bastable, "Tax is a compulsory contribution of the wealth of a person or body of persons for the service of public powers."

Features of Tax

From various definitions, it is clear that a tax has the following characteristic features :

(*i*) Tax is a compulsory payment. Non-payment of tax leads to punishment.

(*ii*) Tax involves some sacrifice to the tax payer.

(*iii*) Income collected through taxation is spent not for the benefit of certain individuals but on public welfare.

(*iv*) There is no quid pro quo between the amount of the tax paid and the benefit received. In other words, the individual who pays tax cannot claim an equal amount of benefit in return.

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(v) Payment of tax is the personal responsibility of an individual.

(vi) Tax imposition follows a legal procedure. It is levied in accordance with certain law.

3. CHARACTERISTICS OF A GOOD TAX SYSTEM

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Broadly speaking a good tax system is that which (a) conforms to the basic principles of taxation and (b) which helps in achieving the socio-economic objectives of the country. The important characteristics of a good tax system are given below :

(i) A good tax system should conform to the canons of taxation. That is, it should have the qualities of equality, certainty, convenience, economy, productivity, elasticity, diversity, simplicity and neutrality.

(ii) A good tax system should ensure maximum social advantage.

(iii) Individuals should be taxed according to their ability to pay.

(iv) Taxes should be universal in the sense that persons in the same financial position should be treated in the same way without any discrimination.

(v) Taxes should be chosen so as to minimise interference with economic decisions in otherwise efficient markets. Such interferences impose 'excess burdens.'

(vi) Where tax policy is used to achieve other objectives, such as to grant investment incentives, this should be done so as to minimise interference with the equity of the system.

(vii) The tax system should permit fair an non-arbitrary administration and it should be understandable to the tax payer.

(viii) Administration and compliance cost should be minimum.

(ix) A good tax system should be a balanced one. It should not rely on a single tax but should have a healthy combination of various types of taxes.

(x) It should be productive of revenue to the government. Productivity does not simply mean revenue returns. Productivity also ensures adequacy, regularity and flexibility.

(xi) Taxes are not merely meant for collecting revenue. They must also facilitate the fiscal policy of the country to achieve the objectives of redistribution of income, stabilisation of the economy and economic growth.

(xii) A good tax system should not hamper the development of trade and industry. Rather it should aim at accelerating economic development by providing incentives for work, saving and investment. In a developing economy in particular, it should be able to mobilise the economic surplus generated in the economy.

(xiii) A good tax system should also take into consideration the rights and problems of the tax payers.

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4. CANONS OF TAXATION

A good tax system, in order to achieve its objectives efficiently and effectively, must follow certain principles. Adam Smith was the first economist to have given a set of fundamental principles, which he called the canons of taxation.

Adam Smith's Canons of Taxation

Adam Smith's celebrated four canons of taxation are given below :

1. **Canon of Equity.** A good tax is that which is based on the principle of equality. In the words of Adam Smith, "The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities ; that is, in proportion to the revenue which they respectively enjoy under the protection of the state." This canon observes the objective of economic justice. In other words, the tax should be levied in accordance with the paying capacity of the tax payers. The term 'equity' does not mean that all the individuals should pay equal amounts of tax. Equity means equality of sacrifice. Marginal utility of money is less for the rich in comparison with that of the poor. Therefore, the rich should pay more taxes than the poor.

2. **Canon of Certainty.** The tax which an individual is to pay ought to be certain and not arbitrary. In the words of 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 to clear and plain to the contributor and to every other person." In other words, the tax payer must know (*a*) the amount of tax to be paid ; (*b*) the time of payment ; (*c*) the method of payment; (*d*) the place of payment ; and (*e*) the authority to whom the tax is to be paid.

3. **Canon of Convenience.** The method and timing of the tax payment should be, as far as possible, convenient to the tax payer. As Adam Smith says, "Every tax should be levied at the time or in the manner, in which it is most likely to be conventient for the contributor to pay it."

4. **Canon of Economy.** The canon of economy implies that the cost of collection of tax should be minimum, *i.e.*, minimum money should be spent in the collection of taxes. According to Adam Smith, "Every tax should be imposed in such a way that besides the amount to be credited to the government treasury, minimum amount should be taken out of the tax payer's pocket."

Other Canons

After Adam Smith, the later economists have propounded some additional principles of taxes which are summarised below :

5. **Canon of Productivity.** This canon is given by Bastable. According to this canon, the tax system should be able to yield enough revenue to the government. In this way, a single productive tax is better than many unproductive taxes.

6. **Canon of Elasticity.** The tax system should be such that, when the need arises, the government can increase or decrease its revenue with a slight modification in the rates of taxes. In other words, at the time of necessity, increased revenue may be obtained from the same tax.

7. **Canon of Diversity.** According to this canon, instead of single tax system, multiple tax system should be adopted. In other words, the tax system should have every type of tax so as to enable every body to contribute something to the government.

8. **Canon of Simplicity.** The tax system should not be complicated. It should be so simple that even a common citizen can understand it. This will reduce tax evasion.

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9. Canon of Buoyancy. The taxation system should be such that the reve collected increase or decrease automatically and fairly quickly with an increase decrease in national income.

10. Canon of Neutrality. Canon of neutrality implies that the taxes should interfere with the otherwise efficiently functioning economic system. In other wo it should not have inflationary or deflationary effects.

11. Canon of Coordination. In modern times, central, state and local governme levy taxes separately. There should be coordination in these taxes.

12. Canon of Desirability. New taxes should be imposed only for some va reasons so that their desirability can be explained to the people.

13. Canon of Popularity. Taxation system should be popular so that the governme may not face any opposition from the people.

14. Canon of Administrative Efficiency. From the point of view of administrati efficiency, the tax system should fulfil the following requirements :

(*i*) Taxes should be based on simple and clear definitions.

(*ii*) Taxes should embrace all types of beneficial receipts of people.

(*iii*) The tax return filed by the assessee should contain all information, such income, expenditure, wealth etc., so as to enable a self checking system taxation to be operative.

Q.2 (b) Function = Classification.

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10 CLASSIFICATION OF TAXATION

1. CLASSIFICATION OF TAXES

Taxes have been classified in different ways depending upon the form, nature, aim, and method of taxation. Important classifications are described below :

(1) **On the basis of form :**

(*a*) Direct taxes (*b*) Indirect taxes

(2) **On the basis of methods :**

(*a*) Proportional tax (*b*) Progressive tax

(*c*) Regressive tax (*d*) Degressive tax

(3) **On the basis of assessment :**

(*a*) Ad valorem tax (*b*) Specific tax

(4) **On the basis of volume :**

(*a*) Single tax (*b*) Multiple tax

Various types of taxes are described below :

(1) **Direct taxes :** Direct taxes are those which are paid by the person on whom they are imposed. The burden of the direct tax is bòrne by the person on whom it is imposed. According to Dalton, "A direct tax is really paid by the person on whom it is legally imposed," Income tax is an example of direct tax. Main advantages of direct taxes are that they are equitable, certain, elastic, and productive. They also reduce income inequalities and arouse civic consciousness. The defects of direct taxes are that they are unpopular, inconvenient and uneconomical ; they can be evaded. ; they have narrow base ; they discourage capital formation .

(2) **Indirect taxes :** Indirect taxes are those which are imposed on person, but are really paid by some body else. In other words, the impact and incidence of indirect tax falls on different persons. According to Dalton, "An indirect tax is imposed on one person but paid partly or wholly by another." Custom duty, excise tax, sales tax,

are the examples of indirect taxes. Chief merits of indirect tax are that they are convenient, difficult to evade, elasic, equitable, broad-based, and check harmful consumption. The drawbacks of indirect taxes are that they are regressive, uncertain, uneconomical, inflationary, less productive and can be evaded.

(3) **Proportional Tax :** Proportional tax is that whose rate remains uniform irrespective of the size of income. In other words, it does not change with the change in income. For example, if the rate of tax is 10%, then a person with ₹ 5000 as his income, will pay ₹ 500 and a person with income of ₹ 10000 will pay ₹ 1000 by way of tax.

(4) **Progressive tax :** Progressive tax is a tax whose rate increases with every increase in income. Higher the income, higher will be the rate of tax ; lower the income, lower will be the rate of tax. For example, for income ₹ 5000, the tax rate may be 10% and the amount of tax will be ₹ 500. When the income rises to ₹ 10000, the tax rate rises to 15% and amount of tax will be ₹ 1500.

(5) **Regressive Tax :** Regressive tax is just the opposite of progressive tax. Whereas in a progressive tax, the rate of tax increases with the increase in income, in a regressive tax, the rate of tax falls with the increase in income. For example, when the income of ₹ 5000 is taxed at the rate of 10% and the income of 10000 is taxed at the rate of 8%, it is a regressive taxation.

(6) **Degressive Tax :** Degressive tax is mildly progressive upto a certain point, but after that it becomes proportional. In other words, under this tax system, the rate of tax increases with the increase in income upto a certain limit. After that limit, the rate of tax becomes uniform.

(7) **Single Taxation :** Single tax system means that there should be only one tax in the country. The tax may be on one commodity or a group of commodities of one type or it may be on the income of the people. Single tax may be proportional, progressive or regressive.

(8) **Multiple Taxation :** Multiple tax system refers to a tax in which all types of taxes are imposed so that every citizen of the country contributes to the state revenue.

(9) **Specific Tax :** When the tax is levied on the basis of the weight, number or measure of the commodity, it is called specific tax. For example, specific excise duty may be levied on cloth as so many paise per metre.

(10) **Ad Valorem Tax :** When the tax is imposed on the basic value of the commodity it is called ad valorem tax. For example, the sales tax on a commodity may be levied as some per cent on its selling price.

(11) **Value Added Tax (VAT) :** Value added tax is a tax on the value added to a good or service. Value added in the difference between a firm's revenue and its payments to other firms. Thus, VAT is determined on the value that a business firm adds to the goods and services purchased from other firms.

(12) **Particular Taxes :** Taxes can be classified on the basis of their particular nature.

(*a*) Income tax
(*b*) Property tax
(*c*) Taxes on producti
(*d*) Taxes on consumption

(e) Taxes on capital goods (f) Taxes on consumption goods
(g) Custom duty (export duty and import duty)

2. DIRECT AND INDIRECT TAXES

The most important classification of taxes is that between direct and indirect taxes. This classification has been made on the basis of the tax burden.

Direct Taxes

Direct taxes are those which are paid by the person on whom they are imposed. According to Dalton, "A direct tax is really paid by the person on whom it is legally imposed." According to Samuelson, "Direct taxes are levied directly on people." In the words of Anatol Murad, "Direct taxes are those taxes which cannot be shifted and which, therefore, fall directly on the persons from whom the government extracts the payment."

Technically speaking, in case of direct taxes, the impact and incidence of tax falls on the same person and there is no possibility of shifting. Impact refers to the immediate burden of a tax and incidence to the burden. For example, income tax is a direct tax because it is imposed on the income of a person and person himself bears its burden.

Merits of direct Taxes

Direct taxes have many advantages :

(1) **Equitable :** Direct taxes are equitable because they are imposed according to the paying capacity of a person. They have an element of progression. Therefore, their burden is less on the poor and more on the rich.

(2) **Economical :** Direct taxes are economical because (*a*) their cost of collection is very low as they are usually collected at source ; and (*b*) they are paid direct to the government and thus the whole amount of tax is deposited in the state treasury.

(3) **Certain :** Direct taxes are certain. The tax payer knows whom, where and how much he has to pay. The government also knows for certain how much income it will get in the form of taxes.

(4) **Elastic :** Direct taxes are elastic in the sense that (*a*) with the increase in country's income, the revenue of the government also increases; and (*b*) the government can increase or decrease its income by changing the rates of these taxes.

(5) **Productive :** Since the cost of collection of the direct taxes is relatively low, the government can get considerable amounts of revenue from these taxes.

(6) **Convenient :** Direct taxes are convenient to pay because the manner and time of collection of these taxes is according to the convenience of the tax payer. For example, income tax is deducted at source at the payment of the salaries.

(7) **Civil Consciousness :** Direct taxes also have an educational value. They arouse civic consciousness among the tax payers and the tax payers take interest in the manner in which the public money is spent by the government. The tax payers become aware of their rights and responsibilities as citizens of the country.

(8) **Distributive Justice :** Distributive justice is secured through direct taxes. The direct taxes are generally progressive in nature, higher income groups of people are charged higher rates of taxes. These taxes help in reducing the inequalities of income and wealth.

Demerits of Direct Taxes

Important drawbacks of direct taxes are as follows :

(1) **Inconvenient :** Direct taxes are inconvenient to the tax payer in many ways.

(*a*) The tax payers get their incomes in bits, but they have to pay their taxes in lump.

(*b*) The tax payers have to keep proper accounts of their income which every body cannot do.

(*c*) The tax payers have to go to the government offices from time to time to get their accounts examined.

(*d*) The tax payers have to undergo the complicated process of filing tax returns.

(*e*) The tax authorities also harass the tax payers in a number of ways.

(2) **Unpopular :** Direct taxes are unpopular because they are painful and the burden is directly felt by the payer.

(3) **Evasion of Taxes :** There is also the possibility of tax evasion. The tax payers evade these taxes by concealing their incomes and showing false accounts.

(4) **Arbitrary.** Direct taxes are not determined and imposed in some scientific manner. Government official often fix the rate of taxes arbitrarily.

(5) **Narrow Base :** Direct taxes cover only a small part of the population. This is particularly the case with underdeveloped countries where most of the people have their incomes lower than the taxable limit.

(6) **Discourage Capital Formation :** High rates of direct taxes may adversely affect the desire and ability to work, save and invest of the tax payers. In this sense these taxes discourage capital formation in the country.

(7) **Discourae Foreign Investment :** Heavy direct taxes also discourage foreign investors to make investment in the country. This affects adversely the process of economic development.

(8) **Uneconomical :** Direct taxes are uneconomical because of high cost of tax collection. This is particularly true when the number of tax payers is large and the amount of tax to be collected is very small.

Indirect Taxes

Indirect taxes are those which are imposed on one person, but are really paid by somebody else. The initial burden or impact of an indirect tax is on one person, but he shifts this burden to another person. Thus, the final or real, burden or the incidence of the tax is borne by some other person. In other words, in case of indirect taxes the impact and incidence of the tax fall on different persons.

According to Dalton, "An indirect tax is imposed on one person, but paid partly or wholly by another." In the words of Anatol Murad,"Indirect taxes are those taxes

...ich are shifted and the incidence of which is on other than the original payers." ...ording to Samuelson, "Indirect taxes are usually defined as taxes that are levied ...inst goods and services and thus indirectly on people." Custom duty, excise tax, ...les tax, etc. are the examples of indirect taxes.

...erits of Indirect Taxes

The following are the merits of indirect taxes :

(1) **Convenient :** Indirect taxes are convenient to the tax payer as well as the ...ate. (a) The tax payer pays the tax in small amounts and thus does not feel the ...urden of it. (b) The tax becomes a part of the price and the consumer does not feel ...at he is paying the tax. (c) The tax is collected at the time when the consumer is able ...o pay it, *i.e.*, at the time of purchasing the commodity. (d) These taxes are easy to ...ssess as they are assessed at the flat rates. (e) Realisation of these taxes is also ...onvenient because they are collected at the appropriate point from the producers, ...mporters and exporters.

(2) **Evasion Difficult :** Indirect taxes are difficult to evade because the tax is ...ixed up with the price. Whenever a person purchases a commodity, he has to pay the tax.

(3) **Elastic :** Indirect taxes are elastic. A little change in the rate of tax (say sales ...ax) changes the quantity of tax considerably.

(4) **Equitable :** Indirect taxes are equitable because they are imposed on such commodities which are purchased by consumers according to their ability. Therefore, they are imposed heavily on luxuries consumed by the rich.

(5) **Check Harmful Consumption :** Indirect taxes on harmful goods like wine, narcotics, tobacco, etc. check the consumption of these goods. In this way, these taxes serve a great social purpose.

(6) **Broad Based :** Indirect taxes make the tax structure of the country broad based. They are applicable to the entire production of the country. They are levied on both the rich and the poor. In other words, every body pays these taxes in one form or the other.

(7) **Influence Investment and Production :** Indirect taxes can influence the investment and production of the country. The government can encourage investment in priority sector by imposing higher rates of taxes on low priority products and giving tax relief to the high priority manufacturers.

(8) **Progressive :** Indirect taxes can be made progressive if the luxuries are taxed heavily and essential commodities are exempted from taxes.

(9) **Protection Possible :** Indirect taxes, like import-export duties can protect the domestic industries from foreign competition.

Demerits of Indirect Taxes

The main demerits of indirect taxes are given below :

(1) **Regressive :** Indirect taxes are generally regressive in nature. Since the rate of tax is equal for all, its burden falls more on the poor and less on the rich. For

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example, taxes on necessaries of life will mean taxing the rich and the poor alike. In this way, these taxes are not just.

(2) **Uncertain** : Indirect taxes are uncertain because the government cannot make correct estimates of its income from these taxes. The income from indirect taxes depends upon many factors like demand for goods, volume of production, prices of goods, etc.

(3) **No Civic Consciousness** : Indirect taxes inspire no public spirit because these taxes remain hidden in the price of the commodity and the tax payer (the consumer) does not feel the burden of the tax.

(4) **Uneconomic** : Indirect taxes are uneconomical in the sense that the government has to spend large amounts of funds on officials to collect the taxes.

(5) **Tax Evasion** : Through smuggling of goods and keeping false accounts, indirect taxes can also be evaded.

(6) **Inflationary** : Excessive use of indirect taxes raise the prices of goods, leading to alround rise in prices and thus generate inflationary tendencies in the economy.

(7) **Less Productive** : Indirect taxes affect production and trade adversely. They raise the prices of goods and thus reduce their demand.

(8) **Against the Consumer** : Indirect taxes are against the interests of the consumers. (a) Many times the sellers charge the tax from the consumers, but do not pay it to the government. (b) In the garb of tax, they charge more money from the consumers.

Distinction between Direct and Indirect Taxes

Economists have distinguished between direct and indirect taxes differently.

(1) **On the Basis of Incidence of Taxation** : J.S. Mill, the physiocrats and others have distinguished between direct and indirect taxes on the basis of incidence of taxation. If the incidence of a tax rests upon the person who bears its impact, it is a direct tax. If, on the other hand, the incidence of tax is passed on to others, then it is an indirect tax.

(2) **On the Basis of Shifting** : Some economists have drawn distinction between direct and indirect taxes in terms of shiftability. Direct taxes are not shiftable, while indirect taxes are shiftable.

(3) **On the Basis of Imposition of Tax** : Direct and indirect taxes have also been distinguished on the basis of imposition of tax. For example, some economists maintain that while taxes on production are direct, those on consumption are indirect. Similarly, it is claimed that taxes on income are direct, but those on expenditure are indirect. It is to be noted that these types of distinctions do not have a sound economic basis.

(4) **On the Basis of Tax Paying Ability** : A sound economic basis for distinction between direct and indirect taxes is provided by the principle of tax paying capacity of the taxpayer. In the case of direct taxes, the liability is determined with direct reference to the taxpaying ability of the taxpayer, while in the case of indirect taxes such an ability is assessed indirectly.

For example, income tax is a direct tax because here the taxpaying ability is assessed directly in relation to the income of the assessee. On the contrary, an excise duty is an indirect tax. Suppose, each piece of television is taxed at the rate of 20% of its value. Then it is assumed that a person who purchases a television will have this capacity to pay the tax and one who purchases a costlier television will have a greater ability to pay. Indirect taxes may be specific or ad valorem, while direct taxes are not.

Complementarity between Direct and Indirect Taxes (Marco's View)

Italian economist Antonio de Viti de Marco is of the view that direct and indirect taxes are complementary to each other and therefore both are necessary for a sound tax system.

(*i*) In the case of direct taxes, people try to evade their income. Indirect taxes are levied on consumption and so are raised on that part of income also which was concealed.

(*ii*) The income of many individuals changes from time to time. So the direct taxes fail to cover the whole of income. Indirect taxes on consumption remove this limitation because with a change in a person's income his consumption also changes.

(*iii*) Indirect taxes cannot be levied on commodities consumed by producers. Direct taxes can be levied on them to compensate the above loss.

(*iv*) Indirect taxes cannot be levied on all types of commodities and services. The remaining commodities and services can be taxed directly.

(*v*) Indirect taxes can also be evaded. Direct taxes are complementary to them in so far as they help the realisation of this evaded part.

(*vi*) Direct taxes involve direct pain and irksomeness and thus create some frictional forces. Indirect taxes, on the other hand, are collected conventionally at the time when income is spend and the taxpayer really feels the burden. Thus, imposition of both types of taxes help in minimising the frictional forces involved in the collection of both.

Conclusion : Choice between Direct and Indirect Taxes

As regards the choice between direct and indirect taxes, the general conclusion is that both types of taxes have their relative merits and demerits. Therefore, it is neither desirable nor feasible to choose one and discard the other. For making a tax structure just, equitable and broad-based, both direct and indirect taxes are essential because one type of tax removes the defects of the other. What is thus needed is a proper balance between the two. Gladstone, the former Prime Minister of U.K. regarded direct and indirect taxes like two attractive sisters to whom the finance minister must pay equal respect.

3. PROPORTIONAL PROGRESSIVE REGRESSIVE AND DEGRESSIVE TAXATION

On the basis of the relation between tax rate and tax base, taxation can be classifed as (*a*) proportional taxation, (*b*) progressive taxation, (*c*) regressive taxation and (*d*) degressive taxation.

Proportional Taxation

Proportional tax is that whose rate remains uniform irrespective of the size of income. The rate of proportional tax has no link with the income of the tax payer, it does not change with the change in income. For example, (as given in Table-1A), the tax is 10%, then a person with ₹ 5000 as his income will pay ₹ 500 and a person with the income of ₹ 10000 will pay ₹ 1000 by way of tax.

In legal terms, tax base represents the object to which the tax applies, such as the income of an individual' 'the value of a property' and so on. The term 'tax rate' refers to the amount of tax per unit of the tax base. Thus, in case of proportional tax, the tax rate remains the same for each unit of tax base. Graphically, (Figure-1A), a horizontal line TT represents proportional tax. It indicates that the tax rate remains unchanged whatever the tax base may be.

Merits : The arguments in favour of proportional tax are :

(*i*) Proportional tax is very simple and every body can understand without any difficulty.

(*ii*) Administratively, it can be easily decided and enforced.

(*iii*) It enjoys the advantage of certainty. Both the taxpayer and the state are certain about the amount of tax.

(*iv*) It maintains the existing distribution of income and wealth of the country.

(*v*) It is advocated when the authorities are unable to decide the proper degree of progression.

(*vi*) It leave the taxpayer in the same relative economic status as he was before the tax is imposed.

(*vii*) It does not adversely affect the people's desire to work and save.

Demerits : The following are the main defects of proportional taxation :

(*i*) It does not result in just and equitable distribution of the burden of taxation. Under this system, the poor make greater sacrifice than the rich.

(*ii*) It does not reduce the inequalities of income and wealth.

(*iii*) The government also cannot get much revenue due to low rate of tax.

(*iv*) It is not elastic.

Table–1

Income	Proportional Tax		Progressive Tax	
	Tax Rate (%)	Amount of Tax (₹)	Tax Rate (%)	Amount of Tax (₹)
5000	10	500	10	500
10000	10	1000	15	1500
[illegible]	10	1500	20	3000
[illegible]	10	2000		

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Progressive Taxation

Progressive tax is a tax whose rate increases with every increase in income; higher the income, higher will be the rate of tax; lower the income, lower will be the rate of tax. For example, (as given in the Table–1), the tax rate may be 10% for income ₹ 5000, 15% for income ₹ 10000, 20% for income ₹ 15000 and 25% for income ₹ 20000. Thus, the amount of tax will be ₹ 500, 1500, 3000 and 5000 for income ₹ 5000, 10000, 15000 and 20000 respectively. A progressive tax thus not only yields revenue to the government, but also makes the distribution of income equitable. It is higher on the rich sections and lower on the poor sections of the society. Graphically, (Figure–B), an upward rising curve TT represents progressive tax. It indicates that the tax rate rises with every increase in the tax base.

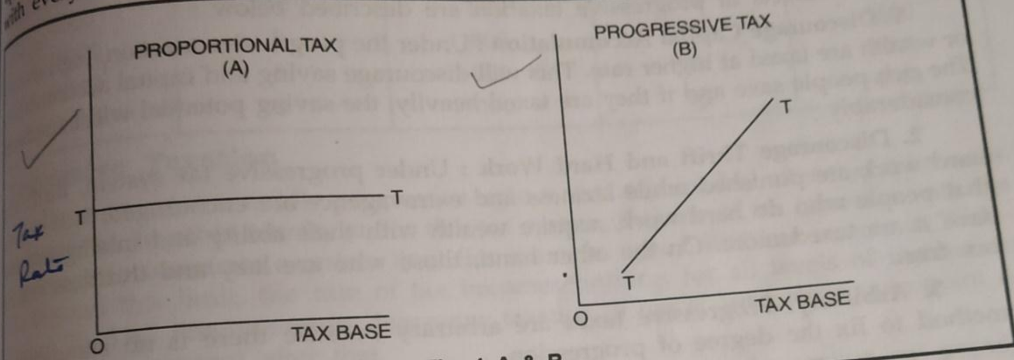

Fig. 1 A & B

Merits of Progressive Taxation

Various advantages of progressive taxation are described below :

1. **Equitable :** Progressive taxes are in accordance with the principle of equity. Such taxes are devised on the basis of the ability to pay of the people; large tax burden is on the rich and less on the poor.

2. **Element of Surplus in Higher Income :** Progressive taxes are justified on the ground that higher incomes have a surplus above cost. Therefore, the ability to pay of the higher income group is high.

3. **Maximum Social Welfare :** Progressive taxes are favoured on the basis of the law of diminishing marginal utility. As income increases, the marginal utility of money falls. This implies that the marginal utility of money to the rich persons is low as compared to that of the poor. Thus, taxing the rich at a higher rate and spending this money on the poor will tend to maximise the welfare of the society.

4. **Equitable Distribution of Wealth :** Progressive taxes reduce the inequalities of income and wealth and thus lead to the equitable distribution of income and wealth in the country.

5. **Economical :** Progressive taxes are economical in the sense that their cost of collection does not increase with the increase in the tax rate. Thus, higher tax rates bring the revenue to the government.

6. Elastic : Progressive taxation is more elastic. In times of need, the governm... can collect more funds by raising the rate of tax on the rich, while leaving the po... unaffected.

7. More Productive : Progressive taxation provides sufficient income to the sta... This income automatically increase with the increase in economic activity in the coun...

8. Economic Stability : Economic stability requires an increase in the purcha... power of the people during depression and its reduction during boom period. Throu... progressive taxation, the purchasing power can be increased by lowering the tax ra... and it can be reduced by raising the tax rates.

Demerits of Progressive Taxation

Main defects of progressive taxation are described below :

1. Discourage Capital Accumulation : Under the progressive taxation, high incom... or wealth are taxed at higher rate. This will discourage saving and capital accumulatio... The rich people save and if they are taxed heavily, the saving potential will be reduce... considerably.

2. Discourage Thrift and Hard Work : Under progressive tax system, thrift and hard work are punished while laziness and extravagance are encouraged. It is argued that people who do hard work, acquire wealth with their ability and intelligence and save it are taxed more. On the other hand, those who are lazy and thriftless remain tax free.

3. Arbitrary. Progressive taxes are arbitrary because there is no standardised method to fix the degree of progression.

4. Faulty Basis : Progressive taxation is based on the faulty assumption that marginal utility is less to a rich person than to a poor person. In fact, utility is something subjective which cannot be measured quantitatively.

5. Possibility of Tax Evasion : There is greater possibility of tax evasion under progressive tax system. A person has to pay higher rate of tax as his income increases. This creates a desire of tax evasion in him.

6. Practical Difficulties : There are certain practical difficulties in adopting progressive tax system :

(*a*) The principle of progression is applicable to a few taxes.

(*b*) The exemption of a minimum subsistence also presents difficulties.

(*c*) The modern governments need so much resources that the funds collected through progressive taxation alone may become inadequate.

(*d*) Progressive taxation is also difficult to understand.

Conclusion. Both proportional and progressive taxation have their relative merits and demerits. But, the principle of progression has now been widely recognised and is increasingly used to promote social justice and reduce inequalities of income.

Regressive Taxation

Regressive tax is just the opposite of progressive tax. In a progressive tax, the rate of tax increases as the income increases ...

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...th the increase in income. For example, (Table–2). At income ₹ 5000, the tax rate is ...%. When income increases to ₹ 10000, 15000 and 20000, the tax rate falls to 8%, 6% and 5% respectively. Graphically, (Figure-2A), a falling TT curve represents regressive tax. It shows that the tax rate falls as the tax base increases. Regressive taxation is socially unjust and yields very little revenue to the government. Under this system, tax burden is higher on the poor sections and lower on the rich sections of society.

Table–2

Income (₹)	Regressive Tax		Degressive Tax	
	Tax Rate (%)	Amount of Tax (₹)	Tax Rate (%)	Amount of Tax (₹)
5000	10	500	10	500
10000	8	800	15	1500
15000	6	900	20	3000
20000	5	1000	25	4000

Degressive Taxation

Degressive tax is mildly progressive upto a certain point, but after that it becomes proportional. In other words, under this tax system, the rate of tax increases with the increase in income upto a certain limit (for example, upto ₹ 10000 as income in Table–2). Beyond this limit, the rate of tax becomes uniform for all levels of income. In Figure 2B, TAT line represents degressive taxation. It has a rising slope upto point A, but becomes constant after that.

In modern times, both regressive and degressive types of taxes are not popular and therefore, are not levied by the governments.

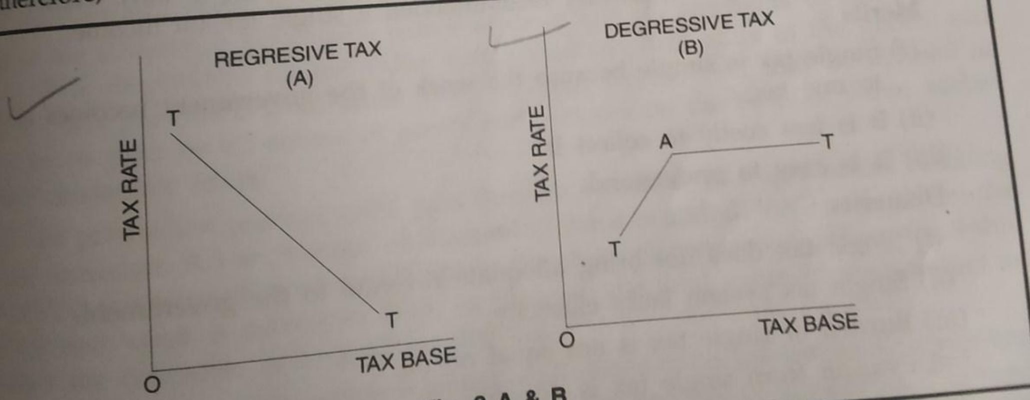

Fig. 2 A & B

4. OTHER TYPES

Ad Valorem Tax and Specific Tax

A commodity tax may be classified into (a) ad valorem tax and (b) specific tax.

1. Ad Valorem Tax : When the tax is imposed on the basis of value of commodity it is called ad valorem tax. For example, the sales tax on a commodity may be levied as some percent (say 5%) on its selling prices. The advantage of this tax is that it is equitable in incidence. Since it is based on the value of the commodity, the canon of ability to pay is fulfilled. This tax falls more heavily on the richer sections of the society. The defect of this tax is that it is difficult to administer and collect particularly when the trader is not honest. It is not easy to assess the value of the commodities.

2. Specific Tax : When the tax is levied on the basis of weight, number or measure of the commodity, it is called specific tax. For example, specific excise duty may be levied on cloth as so many paise (say 10 paise) per metre. The advantage of specific taxes is that they are easy to administer and collect. The collection of these taxes is also convenient. The disadvantage of specific taxes is that they are regressive in nature. When the sane specific tax is imposed on different qualities of goods, relatively higher tax burden falls on low quality cheap goods which are mostly consumed by the poor.

Single and Multiple Taxation

A country may adopt single tax system or multiple tax system.

1. Single Tax System : Single tax system means that there should be only one tax in the country. The tax may be on one commodity or a group of commodities of one type. Or, it may be on the incomes of the people. The single tax may be proportional, progressive or regressive in nature. This type of tax is generally collected regularly at shorter or longer intervals (*e.g.,* after every month or after every year).

Physiocrates during 17th and 18th century propounded the theory of single tax on land. Their argument was that agriculture was the only productive activity which yields surplus. Therefore, tax should be imposed on landlords only. Henry George and Sherman during 19th century recommended a single tax on income.

Merits :

(*i*) Single tax is simple because the work of the government becomes easy due to one tax.

(*ii*) It is less costly to collect it.

(*iii*) It is easy to understand.

Demerits :

(*i*) Single tax does not bring adequate revenue to the government.

(*ii*) Single tax system lacks elasticity.

(*iii*) Burden of single tax is not equal on all.

(*iv*) Evasion from single tax is possible.

(*v*) Single taxation is not realistic and therefore is adopted nowhere in the modern world.

2. Multiple Tax System : Multiple taxation refers to a tax system in which all types of taxes (such as income tax, expenditure tax, sales tax, etc.) are imposed so that every citizen of the country contributes to the state ... the objective of taxation is not merely to rai...

many other socio-economic objectives for which multiple tax is preferred to single tax system.

Merits :

(i) Multiple taxation can raise sufficient resources to the government.

(ii) Multiple taxation is more flexible as compared to single tax system.

(iii) It is based on the principle of equity.

(iv) It is also a comprehensive system.

(v) This system helps to achieve the objectives of economic growth, economic equality and social justice.

(vi) It is more efficient and can check the tendency of tax evasion.

(vii) Under the multiple tax system, defects of one of tax can be removed by other taxes.

Demerits.

(i) Multiple tax system is more complicated than single tax system.

(ii) It is also not a simple system to be easily understood by the common man.

(iii) It is not based on the principle of ability to pay.

(iv) Sometimes, too many taxes hinder the growth process of the country.

Q.4 (a) Meaning of Taxable Capacity

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Taxable Capacity

INTRODUCTION

Taxable capacity is of great significance in modern days for the administration of public finance. It measures to what extent taxes can be imposed without creating any harm to the interest of individual. Even in recent times, notion of the taxable capacity has become the order of the day owing to growth of public expenditures by welfare states and its commitment to economic planning for development.

We are familiar that tax is the major resource of public income or revenue and high taxation leads to increase in the revenue of the public authority. On the other side, it also reduces the purchasing power of the people and adversely affects their ability and willingness to work, save and invest. Therefore, taxable capacity sets the limit beyond which government cannot raise the taxes. Again, we are interested to know whether the public has the capacity to bear the additional burden of taxes.

Under these circumstances, the knowledge of taxable capacity is imperative as it imparts information for the mobilisation of maximum resources for economic development. During the period of crisis like war the concept has the great utility to assess the taxable capacity to maximise the limit to which the purchasing power of the people can easily be squeezed. In this manner, taxable capacity occupies an unique place in public finance.

DEFINITIONS OF TAXABLE CAPACITY

(Learn any two definitions)

In simple words, taxable capacity refers to the maximum capacity of a community to contribute by the way of taxation. Taxation Enquiry Commission Report defined as "*Taxable capacity of 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*"[1].

However, the concept of taxable capacity has been defined in diverse manner by different economists as under :

Hugh Dalton : "My general conclusion is that relative taxable capacity is a reality, which can, however, be equally expressed in other terms, while absolute taxable capacity is a myth". He further comments that "Taxable capacity is a common phrase but a confused conception."

D. Fraser : "The taxable capacity of a nation is surely reached when tax-payers are forced to borrow from the banks to pay their taxes."

1. *Taxation Enquiry Commission Report,. Vol. I.*

Findlay Shirras : "Taxable capacity may be defined as the maximum amount which the citizens of a country can contribute towards the expenses of public authorities without having undergone an unbearable strain."

Sir Josiah Stamp : "Taxable capacity is the margin of total production over total consumption. It is the minimum amount which the citizen of a country can contribute towards the expenses of public authorities, without having a really unhappy and downtrodden existence and without dislocating the economic organisation too much."

Ellinger : "The limits would be reached when so much is taken out of the pockets of the tax-payers so that the incentive to produce is reduced and when insufficient remains to provide the necessary capital to make up for wastage and set to work new workers in an increasing population."

R. Musgrave : "Taxable capacity refers to sacrifice the community is able to sustain." Prof. Musgrave also holds the view that in different contexts that arise in determining regional contribution to Federal Finances or the fair contribution of various countries.

R.N. Bhargava : "The limit of taxation as also of expenditure, is indicated by the principle of public finance and should be called the optimum of public finance."

All these definitions have been criticised as they fail to consider the public expenditure. Otherwise volume and character of taxable capacity is meaningless. Hence, Prof. Musgrave suggests that we must hold a broad-view regarding the overall effects of budget as a whole while deciding the optional size of the budget. He, therefore, emphasised that concept of taxable capacity should be replaced by the concept of optional budget.

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Q. 4

FACTORS DETERMINING TAXABLE CAPACITY

The taxable capacity of a country depends on number of factors. The major factors which influence the taxable capacity are summarised below :

1. Size of the National Income. The taxable capacity of a country primarily depends on its size of national income which in turn on the proper use of national resources, skill, technology, investment pattern. However, the greater is the national income, the greater will be its taxable capacity and vice-versa.

2. Size and Rate of Growth of Population. Size and rate of growth of population affects the taxable capacity to a great extent. The larger the population, the lower the taxable capacity. This is because expenditure on consumption will increase with the increase in population. If the growth rate of national income is lower than that of the population, other things being the same, the per capita income will be reduced and vice-versa. As such, countries like India and China with a vast population at galloping growth rate, have a lower taxable capacity than a country having small and constant population.

3. Distribution of Inome and Wealth. The distribution of national income and wealth also influences the taxable capacity of the people. If wealth and income is unequally distributed, taxable capacity is high because it will be easy for the government to raise the bulk of revenue from the richer section of the community by imposing high and progressive taxation. Due to this reason that the ability to pay is much greater in the case of rich persons than those of the poor. On the other hand, if distribution is more equitable, taxable capacity will be low because government needs no revenue to bridge gap between the poor and the rich.

4. Stability and Growth of Income. Taxable capacity would be higher if economy operates smoothly and ensures a stable growth of income. On the contrary, taxable capacity of community will obviously be lower if there are economic fluctuations with serious ups and downs especially during the period of depression.

5. Pattern of Taxation. Taxable capacity depends upon the pattern and methods of taxation. If the tax system is well planned and broad based, it will bring more revenue. Similarly, if it observes the canons of economy and convenience, taxable capacity will certainly be greater.

6. Purpose of Taxation. The purpose of taxation has to do much with the extent of taxable capacity. If revenue, collected by the way of taxation, is used for the betterment of general masses, they will be willing to pay still higher taxes and the taxable capacity will be higher. But if the proceeds from taxes are spent wastefully, people will hesitate to pay taxes and correspondingly taxable capacity will be reduced. Sometimes, this amount is spent to make the payments of external debt, this will reduce the net income of the paying country and vice-versa.

7. Psychology of the Tax Payers. Psychology of the tax-payers plays a vital role to determine the taxable capacity of a country. For instance, during the war, when nation is engaged in the struggle of life and death, people are ready to make any sacrifice. In this context, *Prof. Findlay Shirras* observed, "The psychology of the people has much to do with the extent of taxable capacity. People are often willing to bear heavier taxation on patriotic or sentimental grounds." Therefore, sentiments play considerable role in taxation. In case, people are psychologically depressed, taxable capacity will be reduced automatically.

8. Nature of Public Expenditure. The nature of public expenditure also determines the extent of taxable capacity. When it is used on productive projects, it increases the wealth of the country which in turn increases the taxable capacity. On the contrary, if it is spent on the unproductive projects like production of arms and ammunition or for the payment of interest, the taxable capacity is likely to be reduced.

9. Standard of Living of the People. Standard of living of people affects indirectly the taxable capacity. The higher the consumption expenditure, the higher would be the standard of living. But higher consumption is possible only by higher income group. Hence, only few pockets who have higher standard of living, will be able to have a higher capacity to pay taxes and vice-versa. *Prof. Kaldor* noticed that consumption expenditure is the best measure to determine the tax-paying ability of an individual.

10. Price Level. Taxable capacity depends upon the surplus of money income over expenditure incurred to meet with ever-rising standard of living of the people. This, however, depends upon the prices. If price level is reasonably low and stable, it means a higher taxable capacity. On the other hand, if prices are rising fast, it will lower taxable capacity in real terms.

11. Stability in Income. Stability in income increases the taxable capacity of a country. If the income of the people is stable, regular and not facing violent fluctuations, the taxable capacity is greater. At the same time, if in the near future, it is uncertain, that the people would be willing to save and hoard resulting reduction in the taxable capacity. The income, in under-developed countries like India, is unstable because large proportion of population gets livelihood from agriculture which is totally a gamble of monsoons.

12. Administrative Efficiency. A well and efficient administrative machinery also measures the taxable capacity. If tax collecting machinery is efficient and honest and taxes are uniformly enforced, tax evasion can be avoided which increases taxable capacity. Generally, in under-developed countries, inefficiency is the main reason of low taxable capacity.

13. Economic situations. During the period of the prosperity phase of trade cycle, where manufacturers are making huge profits, the taxable capacity is very high. Similarly, during depression, the people face number of problems like over production and unemployment which certainly reduce the taxable capacity to a greater extent.

14. Political conditions. Political conditions also determine the taxable capacity. Stable political system creates confidence in the minds of tax-payers. If they feel what is taken out from their pockets, has been properly utilised for the welfare of community, they are ready to pay their obligations in time. On the contrary, if political condition is unstable and there is no planned development in the country, this shakes the faith of the tax-payer and this may lower the taxable capacity of the people as a whole.

The above-stated factors exhibit that taxable capacity can be measured by the number of factors. It is not an absolute figure but any change will change the taxable capacity.