Subject: Public finance

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Topic: Introduction to Taxation and Canon of Taxation

M.A. Economics (2nd Semester)

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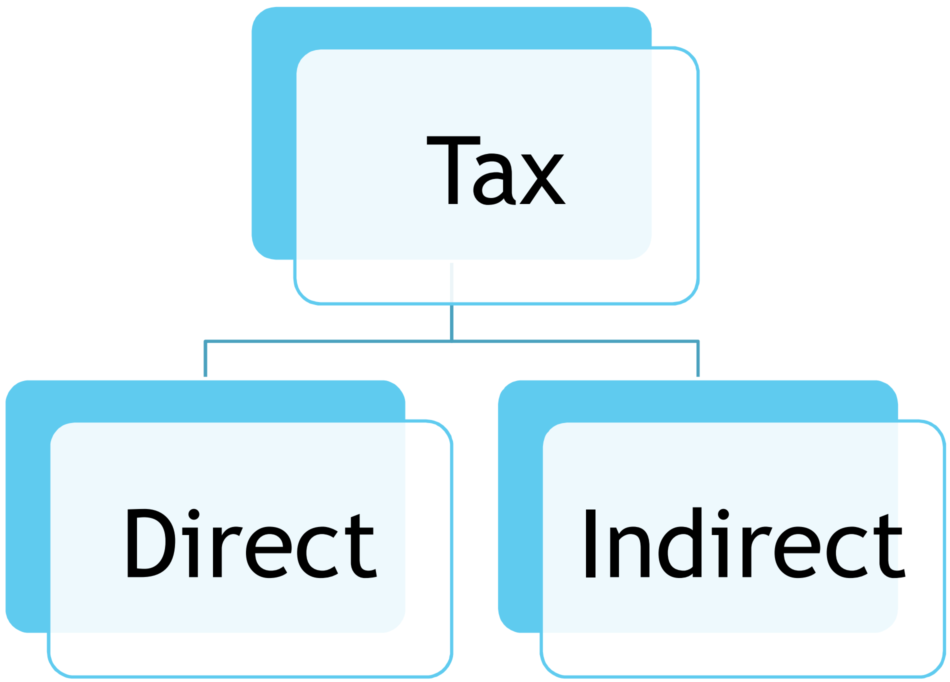
What is Taxation

- The most important source of revenue of the government is taxes. The act of levying taxes is called taxation. A tax is a compulsory charge or fees imposed by government on individuals or corporations.
- The persons who are taxed have to pay the taxes irrespective of any corresponding return from the goods or services by the government. The taxes may be imposed on the income and wealth of persons or corporations and the rate of taxes may vary.

Objectives of Taxes

- Raising Revenue
- Regulation of Consumption and Production
- Encouraging Domestic Industries
- Stimulating Investment
- Reducing Income Inequalities
- Promoting Economic Growth
- Development of Backward Regions
- Ensuring Price Stability

Taxes can be classified into two types



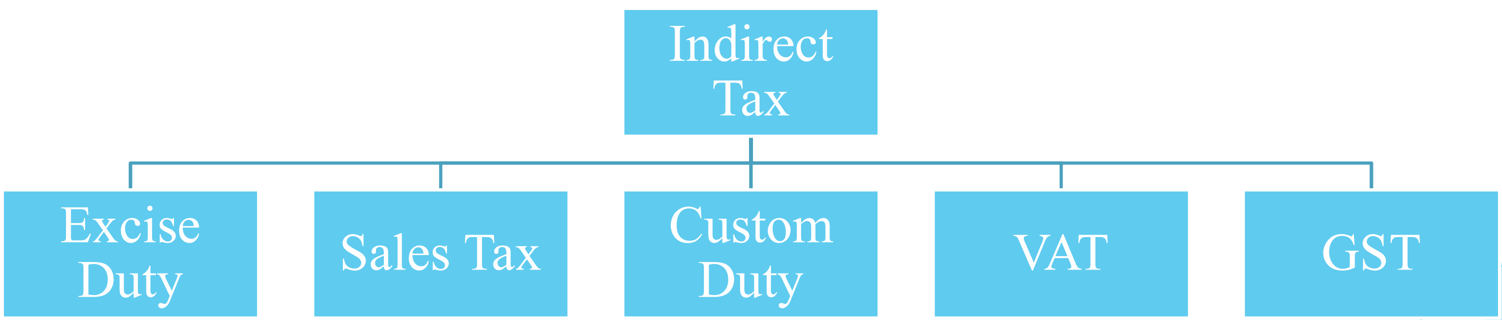
Direct Taxes

A direct tax is that tax whose burden is borne by the same person on whom it is levied. The ultimate burden of taxation falls on the person on whom the tax is levied. It is based on the income and property of a person.

- Direct Tax
  - Corporation Tax
  - Income tax
  - Wealth Tax
  - Gift Tax
  - Property Tax

Indirect Taxes

An indirect tax is that tax which is initially paid by one individual, but the burden of which is passed over to some other individual who ultimately bears it. It is levied on the expenditure of a person.



Meaning of Canon of Taxation

- By canons of taxation we simply mean the characteristics or qualities which a good tax system should possess. In fact, canons of taxation are related to the administrative part of a tax. Adam Smith first devised the principles or canons of taxation in 1776.

- Even in the 21st century, Smithian canons of taxation are applied by the modern governments while imposing and collecting taxes.

Types of Canon of taxation

- In this sense, his canons of taxation are 'classical' in sense, four canons of taxation are:

(i) Canon of equality or equity

(ii) Canon of certainty

(iii) Canon of economy

(iv) Canon of convenience.

- Modern economists have added more in the list of canons of taxation, these are:

(v) Canon of productivity

(vi) Canon of elasticity

(vii) Canon of simplicity

(viii) Canon of diversity.

Canon of Equality

- Canon of equality states that the burden of taxation must be distributed equally or equitably among the taxpayers. However, this sort of equality robs of justice because not all taxpayers have the same ability to pay taxes.
- Rich people are capable of paying more taxes than poor people. Thus, justice demands that a person having greater ability to pay must pay large taxes
- If everyone is asked to pay taxes according to his ability, then sacrifices of all taxpayers become equal. This is the essence of canon of equality (of sacrifice). To establish equality in sacrifice, taxes are to be imposed in accordance with the principle of ability to pay.
- In view of this, canon of equality and canon of ability are the two sides of the same coin.

Canon of Certainty

- The tax which an individual has to pay should be certain and not arbitrary. According to A. Smith, the time of payment, the manner of payment, the quantity to be paid, i.e., tax liability, ought all to be clear and plain to the contributor and to everyone.
- Thus, canon of certainty embraces a lot of things. It must be certain to the taxpayer as well as to the tax-levying authority.
- Not only taxpayers should know when, where and how much taxes are to be paid. In other words, the certainty of liability must be known beforehand. Similarly, there must also be certainty of revenue that the government intends to collect over the given time period.

Canon of Economy

- This canon implies that the cost of collecting a tax should be as minimum as possible. Any tax that involves high administrative cost and unusual delay in assessment and high collection of taxes should be avoided altogether.

Canon of Convenience

- Taxes should be levied and collected in such a manner that it provides the greatest convenience
- not only to the taxpayer but also to the government. Thus, it should be painless and trouble-free as far as practicable. “Every tax”, stresses A. Smith: “ought to be levied at time or the manner in which it is most likely to be convenient for the contributor to pay it.”

We now present other canons of taxation..

Canon of Productivity

According to a well-known classical economist in the field of public finance, Charles F. Bastable, taxes must be productive or cost-effective. This implies that the revenue yield from any tax must be a sizable one. Further, this canon states that only those taxes should be imposed that do not hamper productive effort of the community.

- A tax is said to be a productive one only when it acts as an incentive to production.

Canon of Elasticity

Modern economists attach great importance to the canon of elasticity. This canon implies that a tax should be flexible or elastic in yield. It should be levied in such a way that the rate of taxes can be changed according to exigencies of the situation. Whenever the government needs money, it must be able to extract as much income as possible without generating any harmful consequences through raising tax rates. Income tax satisfies this canon.

Canon of Simplicity

- Every tax must be simple and intelligible to the people so that the taxpayer is able to calculate it without taking the help of tax consultants.
- A complex as well as a complicated tax is bound to yield undesirable side-effects. It may encourage taxpayers to evade taxes if the tax system is found to be complicated.
- A complicated tax system is expensive in the sense that even the most honest educated taxpayers will have to seek advice of the tax consultants.
- Ultimately, such a tax system has the potentiality of breeding corruption in the society.

Canon of Diversity

- Taxation must be dynamic. This means that a country's tax structure ought to be dynamic or diverse in nature rather than having a single or two taxes.
- Diversification in a tax structure will demand involvement of the majority of the sectors of the population.
- If a single tax system is introduced, only a particular sector will be asked to pay to the national exchequer leaving a large number of population untouched. Obviously, incidence of such a tax system will be greatest on certain taxpayers.
- A dynamic or a diversified tax structure will result in the allocation of burden of taxes among the vast population resulting in a low degree of incidence of a tax in the aggregate.

From the above discussion, it follows that taxation serves the following purposes:

(i) To raise revenue for the government

(ii) To redistribute income and wealth from the rich to the poor people

(iii) To protect domestic industries from foreign competition

(iv) To promote social welfare.

Thank You