CHAPTER II

TAX STRUCTURE: MEANING AND SIGNIFICANCE

1. DEFINITION OF TAX STRUCTURE:

The term 'Tax Structure' gained a wide currency in the recent literature on Public Finance. The term 'structure' literally means "the manner in which a building or organism or other complete whole is constructed". It also refers to the "supporting framework or whole of the essential parts of something". Therefore, how taxes are, or should be composed, are questions that relate to tax structure.

In the terminology of fiscal science, the edifice of tax structure is mainly built on tax base and tax rate. The elements of this structure are

(a) number and variety of taxes.
(b) the structure of each tax and
(c) the combination of several taxes.

The structure of each tax is concerned with its (i) base and (ii) its rate. The combination of several taxes indicates the size of the contribution of each single tax to the revenue pool.
While giving a workable definition of tax structure, Ursula Hicks says that it consists in "the distribution of revenue between the different sorts of taxes". She however adds that "this, of course, is not the only, nor even the most interesting way in which we might arrange the revenue. A more interesting arrangement would show how much of the revenue from each tax is derived from families in different economic circumstances".

A study of tax structure, according to her, is ultimately a study of "the relative importance of the different taxes in current fiscal practice".

2. ELEMENTS OF TAX STRUCTURE:

In accordance with the definition given above, the following are the chief elements of tax structure.

(a) determination of the contribution made by the main types of taxes - those on incomes, on capital, and on outlay - to the revenue pool;

(b) determination of the contribution made by the different occupational classes - business classes, propertied classes, professional classes and working classes and
(c) determination of the contribution of the various income groups, that is, various families in
different economic circumstances.

3. BUILDING OF TAX STRUCTURE:

A tax ladder can be constructed in two ways: one to represent the absolute amount of revenue contributed by each tax and the other to represent percentage contribution of all the taxes, the latter being the most important.

A tax structure of a country should be designed in such a way that it will be

(i) capable of reaching most taxable sources i.e., choosing the appropriate taxes that together make up the tax ladder so that significant proportions of the revenue pool are contributed by the desirable types of taxes.

(ii) equitable - both horizontally and vertically - i.e., determining appropriate base and rate for each selected tax in the tax ladder; and

(iii) responsive to the changing economic conditions.
The aim should always be a tax structure that will be adequate, flexible and harmonious with the emerging pattern of economic activity⁵.

The construction of a system of taxation, like all works of art, is the result of a combination of materials derived from different quarters. To attain success it is necessary to bear in mind certain general facts relating to the economic structure of the society; the aim of realising substantial justice in the apportionment of burdens must never be lost sight of, and in addition the technical and financial conditions require to be duly considered⁵.

The problems associated with the design and administration of various taxes differ with the structure of the economy in which it is applied and with its climate of public attitude towards taxation. Tax structures manifestly differ markedly from country to country because of differences in history, political systems and attitudes towards Governments - among other factors⁶. A country's tax structure should be periodically reviewed. The relative dependence on various taxes and on evolving revenue administration must be continually modified. In general
a developing country should obviously build on the tax system it already has, making sure that its major taxes do not get seriously out of date, are progressive in effect wherever possible and are within its administrative capability. As tax structures differ with stages of economic development, the idea that any particular tax structure is uniquely suitable to a particular stage of economic development is an illusion.

4. TAX STRUCTURE AND ECONOMIC DEVELOPMENT:

HINRICHS'9 AND MUSGRAVE'S10 HYPOTHESES:

The various economies of the world are categorized as developed, intermediate, developing and underdeveloped economies. As has been already stated that a tax structure that is particularly relevant and appropriate to any one at a particular stage of development need not and generally is not, equally and simultaneously appropriate to the rest of the economies world. One way of approaching the question of tax structure and development is to explore the ways in which the tax structure has changed historically as economies have evolved.
Hinrichs has sketched out a pattern of tax structure change from primitive to advanced societies as follows:

**FIRST STAGE:** Traditional societies rely primarily on non-tax sources such as fees or levies from state monopolies and/or traditional direct taxes - taxes on land, livestock, agricultural output, water rights and so forth.

**SECOND STAGE:** When the society starts to advance, indirect taxation becomes more important, especially taxes on foreign trade. The extent of reliance on such indirect external taxes depends on the openness of the economy.

**THIRD STAGE:** Meanwhile, traditional direct taxes are likely to decline relative to national income and Government revenue.

**FOURTH STAGE:** As domestic product (based on internal trade and monetization) continues to develop, internal taxes (e.g., sales and excise taxes) grow rapidly and tend to replace import duties. This stage is illustrated by the import substitution and introduction of sales taxes in many developing countries in the last ten years.

**FIFTH STAGE:** When the economy reaches maturity, modern direct taxes (e.g. personal income and corporate profit
taxes) become predominant, as in the United States and the United Kingdom today. The traditional stage - beyond primitive economies but below the advanced stage - is the category that fits most of today's developing economies. Hinrichs generalizes that in the traditional stage there is a rapid increase in the taxes on foreign trade followed by taxes on consumption and transactions. But at the end of the traditional phase, modern direct taxes increase faster than internal indirect taxes. Another question discussed by Hinrichs is that of the flexibility of the tax structure at a given stage of development, or to what extent economies at equal levels of development would have different tax structures. Hinrichs found tax structure flexibility to be a luxury of advanced economies, which has to choose from the variety of bases and can adopt a tax structure fitting their cultural and political conditions.

Another approach to tax structure change has been offered by Richard A. Musgrave. He says that the development of the tax structures will be shaped by economic factors and the broader forces of social and political changes.
The economic factors seem to influence tax structure development, in two ways. As the tax structure of the economy changes with economic development, the nature of the tax base changes as well and with it the 'handles' to which the revenue system may be attached. With the stage of economic development, the economic objectives of the tax policy vary and also the economic criteria by which a good tax structure is to be judged. The effects of development upon the tax structure are more a function of institutional change and less in the nature of an inherently economic matter.

He emphasises that in the early stages of development the economic structure of low income countries imposes several limitations on the structure of the tax system. The tax-GNP ratio of these countries is very low ranging from 8 to 18 per cent which reflects lower taxable capacity as well as low tax efforts. A low income country has less scope for the transfer of resources to public use. At a very low level of per capita income, all private income is needed to meet the very necessities of life such as food and shelter. Unless the public use of funds is to provide equally basic necessities (e.g.,
minimal health and sanitation programmes) the diversion of funds involves an insupportably heavy current burden. The conclusion is that a highly unequal income distribution results in substantial luxury consumption.

Apart from this level and distribution of income, the availability of 'tax handles' is related to the economic structure of the economy. The tax handles are scarce. The role of income tax does not and cannot be expected to occupy a central position in the structure of these countries. Employees of small establishments and the large group of self-employed, especially in agriculture, typically remain outside the orbit of income tax. The administration of an income tax is much more difficult where employment is in small establishments, profit taxation is not feasible until accounting practices attain minimum standards, and it is difficult if firms are small and unstable. Product taxes cannot be imposed at the retail level if retail establishments are small and impermanent.

The predominance of agriculture in these countries and the difficulty of reaching agricultural income through income taxation make land taxes vitally important.
But effective land taxation is difficult where food is home-consumed, the agricultural sector is largely non-monetized and land surveys are inadequate in producing proper valuations.

The feasibility of taxation depends upon how society views the need for compliance, the extent to which the courts are willing to enforce tax laws, and the availability of a competent and honest staff of tax administrators.

Given these difficulties, the strategy of the tax structure development should be adjusted accordingly. Devising a meaningful 'standard model tax structure' for all countries is a difficult task. The weights assigned to particular taxes which are suitable for one country may not be so for another. A highly agricultural country must rely more heavily on land taxation than an industrial one. The accessibility of product taxation is greater in an economy with an urban population permitting large retail establishments than in a decentralised rural economy and so forth.

In the later period of an economy's development, tax authorities are offered a much greater variety of tax
The important feature of these economies is the striking increase in the tax/GNP ratio, from 30 to 60 per cent. In the composition of revenue, the contribution of individual income tax is also higher. This is so because economic organisation of these countries is developed. Concentration of employment in larger establishments and decline of the rural relative to the industrial sector render personal income taxation more manageable. As the operation of private firms is rationalised and accounting practices improved, effective taxation of business income becomes feasible. Thus there is good reason to expect that economic development will bring with it an increase in the share of direct taxes. It is considered that tax structures that rely on direct taxes are held to be more progressive.

Thus, as the economic system advances into that of a highly developed, pecuniary economy, a much wider range of tax bases becomes available. The great bulk of income and output now moves through the market, and the transactions are valued in money terms. The income-expenditure flows may be tapped at almost any point, and revenue be diverted to the treasury. The tax imposition may be on firms or households, on expenditure and receipts,
on products or factor inputs, on flows or on stock and so forth. Thus problems of revenue collection tend to shift from the search for tax bases to the devising of forms of taxation, yielding effective collection from the wide variety of tax bases available. At the same time, problems of enforcement shift from extension of the tax net to plugging loopholes constituting legal means of avoiding tax payment.

Non economic factors - political and social - also cause changes in tax structure. History testifies a close interaction between changes in the political setting and in tax structure; and the standards of tax equity, closely linked with the social philosophy of the time, have always been a major factor in the choice of appropriate tax instruments. The rise of egalitarian philosophy in the 19th and early twentieth centuries led the Governments to attach increasing importance to income tax. In fact, the progressive income tax became a principal instrument of those who held egalitarian views.

Tax structure development over the modern period has been dominated by the rise of direct and especially income taxation. With the transition from feudal to capitalist pattern of social stratification, income emerged as
a welcome substitute for property as a tax base, and subsequently it became accepted increasingly as the most representative index of economic or social status and of fiscal capacity. For a variety of reasons including principally the difficulty of identifying the geographic source of income, the income tax is suited to be a national rather than a state or local tax. On the other hand, the possibility of achieving tax progressivity through indirect taxes on luxury consumption is now receiving much attention. The contrast between regressive indirect taxes and progressive direct taxes has been diminished sharply.

It is obvious from the course of history that the tax structure development began with direct rather than indirect taxes. But with the dissolution of traditional society, the older forms of direct taxation such as the land taxes declined in importance and indirect taxes became the mainstay of the revenue structure. Only with the beginning of 20th century or the closing of the 19th century, there was a renewed shift to direct taxation in the form of income tax, based on the increasingly pecuniary nature of economic life, and the new alignment of social forces, making for chances in the balance of power and calling for progressive taxation.
5. DEVELOPMENT OF MODEL TAX STRUCTURE:

The tax structure varies from country to country depending upon the stage of development. So, it is difficult to generalize about the appropriate overall level of tax revenue and set criteria for the composition of revenues as it should be at a particular time, or for the path of tax structure change as the economy develops. Economic structures vary, not to speak of differences in administrative capabilities, enforcement and cultural traditions. There is no such thing as a perfect tax structure in the absolute sense; its excellence is relative to the economic contexts or financial set-up out of which it emerges and by which it is conditioned. Yet it would be most helpful to the tax policy planning if certain principles are generalized. One of the approaches is to compare the tax structure composition of any one country/State with the average picture provided by countries/States in similar position. So the development of Model Tax Structure applicable to groups of countries with more or less similar characteristics regarding availability of tax bases and levels of per capita income is needed. Given such a model tax structure, the position of individual countries may then be judged in relation to the absolute standards and
by comparison, and the needs of tax structure changes over time may be derived from expected changes in economic structure. Effort in terms of overall revenue may be assessed with reference to the yield of such target structures/model tax structure.

6. **PRINCIPLES OF TAX STRUCTURE PLANNING**

Though it is difficult to set up any model tax plan, yet the following are considered the basic principles of designing the tax structure.¹⁴

1. **The purposes and objectives of a given tax system should be specified clearly.** After a thorough study, the legislators could frame those objectives and place them as a preamble to the tax code.

2. **There should be a scientific effort to proportion the various elements into a balanced array, so as to carry out those objectives.** They should be balanced in relation to a number of criteria:

   (a) **Balanced in relation to rate structure so as to get the right proportioning of progressive, regressive and proportional elements.**
(b) Balanced in relation to exemptions and deductions so as to establish inclusive and yet equitable tax bases.

(c) Balanced in relation to direct and indirect taxes.

(d) Balanced in relation to diversity and unity in the given tax system.

3. Greater effort should be made to co-ordinate and integrate the tax systems of federal, state and local Governments, so that they will function more as a single unified system, free of economic overlapping, duplication and conflict.

4. Conscious effort should be made to co-ordinate and integrate taxation and administration of the tax system into the total fiscal plans and policies of Government at all levels.

7. An Ideal Tax:

A model tax structure would always be a compromise between the ideal characteristics of a tax system and the available bases, because as the economic structures change, the tax structures do change. As a capsule, formulation of a model tax system, we might say that a
Government must first decide on the 'division of labour' between the public and private sector and thus the desired overall level of taxation. Given the overall level of taxation, a desirable group of taxes should balance the following major criteria as suggested by R.A. Kusgrave & P.B. Musgrave and Gerhard Colm.

The criterion of justice involves the concept of being fair, equitable and just in its impact upon taxpayers. The burdens should be reasonably well distributed throughout the tax brackets so as not to be too highly regressive in the lower levels nor too highly progressive at the top. Everyone should be made to pay his due share.

The fiscal criterion projects the notion that the system ought to be adequate to meet the fiscal needs of the taxing units. It also implies the idea of elasticity-automatic increase in revenue in response to the growth in income.

The economic criterion implies that the tax system should have concern for the functioning of the economic system. The idea of fiscal efficiency implies that the tax system should be consistent with the economic policy which may include such objectives as favouring
savings over consumption, raising private investment and producing a favourable impact on balance of payments. A corollary to the above notion is that the tax structure should facilitate the use of fiscal policy for stabilisation and growth. In recent years, a good deal of emphasis is on the idea that taxes should relatively be neutral in their effects—with a minimum of excess burden and uneconomic distortions.

The administrative criterion requires an efficient and non-arbitrary administration. The tax system should be understandable to the taxpayer. The goal of efficiency is to minimize the cost of collecting the taxes in terms of administrative resources and the cost of paying the tax in terms of taxpayer resources.

These criteria are indeed conflicting in nature. Therefore this would result in 'trading off' one criterion against another, based on economic conditions and priority of needs. The model tax structure would thus be a changing one, not only because of change in tax bases but also because of changes in the goals of the tax policy. However, these criteria can make a strong condition to build an optimal tax system for the community.
NOTES TO CHAPTER III:

1. Hicks, Ursula: "Public Finance", Digswell place James, Nisbet & Company Ltd., Cambridge, p. 77.

2. Ibid. p. 78.

3. Ibid. p. 77.


7. Ibid. p. 144.

8. Ibid., p. 18.


12. Ibid.


