Chapter No. 2
Theoretical Framework of Taxation

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2.1. Introduction

Despite notable challenges from the optimal literature, describing the historical perspective that the taxes play an important and pivotal role for the development where the Government in all countries depends on face the requirement of general expenditures by levy of taxes on the people. The important aim of the economic policy is to achieve economic growth of the nation equitable distribution of the wealth and reduction of poverty.

Taking into consideration this aspect, public finance is mainly related to the methods by which the funds are raised to meet the public expenditures. In spite of several revenues of government, taxation plays an important and pivotal role in the development of economic, business, investment and social life in any country. It also has an impact on living standards.

Taxes policy has been an important instrument for augmenting revenue, where it is the major source of domestic revenue. It is also an important instrument for attaining a proper pattern of resources allocation, distribution of income and wealth, reduction of poverty among people and economic stability, in order that the benefits of economic development are evenly distributed.

Increased revenues are desired for many other purpose including expending, socially desired, government current expenditures, or even on pragmatic grounds, as to impress foreign aid donors with evidence of the nation's 'effort' to develop on the basis of domestic resources.

To date, many developing countries still face difficulty in raising income tax revenue to the level required for promotion of economic growth. A poor income tax performance, in term of raising revenue can mean either deficiencies in income tax structure or an inadequate effort to collect, on the part of the government, both of which are influenced by various factors.

Underlying the conceptual argument that the yield of the tax system is a function of the tax bases available, the rates applied to these bases, and the
probability of collecting any specific levy, are of other factors. In other words, the actual amount of tax revenue collected depends only partly on, the taxation potential of the individual countries, the taxation targets set by the authorities, and the ability of governments in practice to collect taxes.¹ Given these, the success of the authorities in exploiting the tax potential and in attaining the taxation target will depend on a number of other factors, which include, the economic structure, the general level of development (reflected in per capital income and levels of literacy, urbanization, communication, etc.), the administrative and political constraints on the fiscal system, social-political values, indigenous institutional arrangement, popular desires for government spending, plus other factors which condition overall willingness to pay taxes.

Government uses taxation not only for the purpose of raising money to carry on with the business of governance but also as an important fiscal tool for economic development. Taxation is used to encourage investment in local industries among others. Consequently priority sectors of the economy such as agriculture, solid minerals, oil and gas, export and manufacturing are given incentives in order to influence purchasing power and production costs both of which are crucial for the growth of industries. With the government recognition of the need to attract foreign investors into the country, diversifying and expanding the export of country as a means of accelerating its economic development as well as the need to encourage existing and intending of industries to operate in the country, various tax incentives have been put in place by the government. This study examines the various tax incentive packages that have been made available by the government to corporate bodies in country and goes further to take a critical look at the efficacy of these incentive packages as a means of accelerating the country's economic development.

When a country's own citizens or residents transact business or invest abroad, or foreigners trade or invest within its domestic jurisdiction, the tax system, as it affects these activities, needs to balance carefully domestic and international economic objectives. On a global basis, countries need to maintain

orderly tax regimes to promote international trade, and there is a need for
accepted rules and conventions limiting any country rights to tax its own citizens
or residents operating or investing abroad, or the citizens or residents of other
countries doing so in its own jurisdiction. Two mainstream principles or bases,
which have developed for this kind of "international" taxation, are respectively the
source and the residence bases. On the international level, a network of bilateral
Double Tax Agreements, which seek to remove any remaining potential conflicts
and to eliminate the danger of taxing the same income twice, then amplifies
these.

The primary purpose of income tax system is to raise revenue for various
government expenditure is pursuit of the government responsibilities outlined
above. In some cases, however, the legislature has found it expedient to use the
income tax system directly in pursuit of its economic or social goals, and to
bypass the need first to raise revenue and then to disburse it through separate
expenditure programmes. Rather than imposing a comprehensive revenue-
raising tax and then redistribute a portion to citizens through direct expenditure, it
can simply distribute benefits through the tax system subsidies to the same
persons who would have received them in a direct expenditure programme, and
in the same proportion to the same persons, it seems inefficient to collect the
money first and then hand it back to taxpayers. In this case, it would obviously be
much more sensible simply to hand the money out through the tax system by
collecting it in the first place.

In effect, the Income Tax Assessment Act consists of tow separate
systems. The first is the revenue raising system based on neutral revenue raising
tax base. The second is an expenditure programme. This part of the tax Act has
nothing to do with collecting revenue. Rather, it is the spending side of the tax
system, the short cut for direct expenditure. The intermingling of these two
programmes in one Act causes considerable confusion. Indeed, a number of
submissions to the EP tax reform deliberations suggested that a first step to tax
reform was separate the two tax programmes into different parts of the Act or into
different Acts; neither has occurred.
The evaluation of our income tax system begins with a concept known as the benchmark income tax base. This is the base upon which the tax system would be constructed if its principle purpose were to raise revenue for the government functions outlined earlier. The benchmark income tax system seeks to measure accurately net economic gains (that is, income) on which tax liability can be based. It identifies a tax system whose only function is to transfer, on a per-determined ability to pay basis, a portion of every taxpayer's income to the government that would then use that income for public purposes. Deviation from that base is presumed to be pursuing other government objectives. Clearly, the provisions designed to achieve government objectives other than neutral revenue rising cannot be evaluated by reference to same criteria as features intended solely to raise revenue. Deviations from the base are simply substitutions for direct expenditure programmes; accordingly, they are usually evaluated to spending programme criteria, quite different from those applicable to revenue raising systems.

All advocates of the free market economic system concede that while this market may make the most efficient use of society's capital resources and potential, it will not always produce the best social returns. There will inevitably be cases in which investment or consumption decisions that are sound in terms of usual economic criteria producing undesirable social political results, in spite of their economic rationality. Thus, for example the provision of media services dictated by the market alone would lead to provision of these facilities in urban areas with large market potentials and the absence of such services lightly populated rural areas. If society develops a consensus that media coverage for the entire nation is desirable, intervention in the free market will be necessary. Similarly, there will be cases where the free market would produce the optimal economic and social result, but cannot because of some per-existing distortion, such as monopolistic control over vital economic sectors. Alternatively, external factors may inhibit or prevent the functioning of features essential to the efficient operation of the free market, such as the provision of adequate information to all investors and consumers.
In these cases where the market is not functioning adequately, or where the government seeks results different from those of the free market, it must intervene in the economy and redirect resources to suit its ends. The income tax system is one of many interventionist tools available to the government; the neural benchmark income tax system identifies deviations from the neutral base so they can then be evaluated by reference to the appropriate criteria.

Section of this chapter explains the meaning and definition of taxation, history of taxation, taxation canons of Adam Smith and others canons, we discuss principles of taxation and purpose of the levy income taxes and its affecting the economic and social live. The following section the impact of income tax in the economic development.

2.2 - Meaning and Definition of Taxation

First of all we have to settle the meaning of the word 'tax.' This term, so clear and simple to the ordinary citizen, has been defined, sometimes at astonishing length, and often unconscious, design of aiding a particular theory as to the character of the facts denoted by it. The following definition is, we believe, correct and quite in accordance with the realities of finance and politics: it has further advantage of not implying unfairly any special view respecting the nature or justice of taxation. A tax is a compulsory payment of money to pay to the Government by an Individuals or Organizations as the Government covers it's expenses on various public functions, and is interference in political, economic and society life without direct return of benefit to be derived by the taxpayer. In other words, there is no direct return to the taxpayer for what he pays, though public in general derives a common benefit. Thus, tax is a mandatory distribution collected by the Government to meet the expenses of various public functions. The principle of taxation should be to impose the least sacrifice on the people as a whole, even if it means imposing more sacrifice on some people and less on other. It is not a price paid by taxpayer for any definite service by Government. Modern Government, being welfare Government, should try to minimize the sacrifice of the community. The aggregate sacrifice of the community is minimum when the marginal sacrifice of individual taxpayers is equal or as nearly equal as
possible. Many economists like Adams, Bastable, Seligman, Taussing, Dalton etc, hold the unanimous opinion that "the tax is a compulsory payment to the Government by taxpayer without any expectation of some specified return."^2

Experts as under have defined the term 'taxes':

1. Adams: "A tax is a contribution from citizens for the support of the state."^3
2. P. E. Taylor: 'A compulsory payment to Government without expectation of direct return in benefit to the taxpayer is known as tax'. 4
3. Prof. Bastable: 'A tax is compulsory contribution of the wealth of a person or body of persons for the services of public powers.5
4. According to Seligman: "A tax is compulsory contribution from the person to the Government to defray the expenses incurred in the common interest of all, without reference to special benefits conferred" 6
5. Plehn." Taxes are in general, compulsory of wealth levied upon persons, nature or corporate, to defray the expenses incurred in conferring common benefit upon the resident of the State."7
6. Dalton. "A tax is a compulsory contribution imposed by a public authority irrespective of the exact amount of service rendered to the taxpayer in return"8
7. The dictionary of Modern Economic: "Taxation means "Compulsory levies on private individuals and organs tons made by government to raise revenue to finance expenses on public goods and services and to control the volume private expenditure in the economy."9

^ Agarwal R.C, Public Finance, "Theory & practice" without of date, published by Lakshmi Narain Agarwal, Hospital Road, AGRA-3, P.63.
^ Dr. Prof Kulkarni M and others, Business Taxation and Auditing, preceding source, 2001,P.2.
Each term in this definition is significant, and helps to explain the object defined. First, a tax is 'compulsory.' This does not mean that all tax revenue is paid unwillingly, but merely that the will of the payer is legally immaterial. The amount, the mode and time of levying, the persons affected, are all determined by the sovereign or its delegate, and individual preferences or dislikes are allowed no place in the act. It thus appears that so-called voluntary taxation is not true taxation, which is plainly the fact; for in the few cases in which it has been tried, Society is either in the pre-political stage in which the public economy exists only in a rudimentary form, or the system is one of self-assessment supported by social rather than legal sanction. It is quite possible that some persons may gain through the operation of a tax of which they themselves pay a part; but it is rather the operation of the tax than its payment by the person affected that produces this result. Every tax necessitates a deduction from the wealth of the contributor, even though compensation may be indirectly brought about through its action.

Thirdly, the term 'wealth' has to be understood in a wide sense, including 'services' as well as commodities. Military service or forced labour for, say, repairing roads (corvées) is taxation quite as much as payment of money or goods.

Fourth, all taxation is imposed on 'persons.' This necessarily follows from the circumstance that the payment of taxation is a duty, and persons only can be liable to duties. The proposition is apparently inconsistent with the division of taxes into 'personal' and 'real,' and also with the taxation of commodities so often mentioned. There is, however, no opposition between the different uses. The term 'real' taxation refers to the 'object' of taxation; the owner or ultimate bearer is the 'subject' of the tax, and he is a person. Taxation of commodities falls on the consumers or other persons connected with the taxed articles, and a similar

analysis will apply to other forms of taxation. The truth, though often forgotten, yet always holds well that a tax must ultimately be paid by some one.

Fifthly, taxation is levied for 'service' or 'benefit.' The public economy requires the supply of its wants, and taxation is the mode of meeting whatever proportion of those wants remains unsatisfied from other parts of the public revenue. The produce of taxation has unfortunately been only too often misapplied, and resulted in injury rather than gain; but the tax-imposing body must be regarded as the final arbiter of the justice of its wants. That some requirements are evil makes them none the fewer requirements in the case either of individuals or of government.

Finally, taxation is for the 'public powers,' i.e. it has to meet the wants of both central and local governments. A rate raised by the smallest parish is as much a tax as if the Imperial Parliament levied it. All contributions to the various organs of government are taxes in the view of finance, whatever is their administrative name. Special kinds of taxation have been often denounced as being for the benefit of classes or individuals, not for that of the State. The advantage obtained by the protected producers may be regarded as equivalent to so much public expenditure in their favour. It is generally incapable of being estimated, but this circumstance is of practical rather than theoretical importance. That all taxes of equal pressure are not of equal advantage, either to the State or the community is too evident to need formal assertion. Otherwise there would be no reason for the selection of any particular forms. From above definitions we find out the taxpayers are required to make certain payments fixed by government. The amount, the types of taxes, the time of payment, all these are determined by government. The government in accordance with the legal procedure imposes taxes, which is subject to parliamentary regulation and control. In a democracy the government has to take the approval of a majority of the representative of the people. Taxes have a compulsory aspect. So their payment the disposable income of the taxpayers.

Thus, they imposed a sacrifice on them. A tax is a compulsory levy payable an economic by a unit to the Government without any corresponding entitlement to receive definite and direct benefits from government. The benefits received by
taxpayers from the government are not related to or based upon there being taxpayers. A tax is a generalized exaction,\textsuperscript{11} which may be levied on one or more criteria upon individuals, groups of individuals, or other legal entities. It may be noted that public receipt containing an element of compulsion does not automatically become a tax.\textsuperscript{12}

We can also mention the case of 'special assessment', which is a kind of a special charge levied on certain members of the community who are beneficiaries of certain government activities or public projects. And certain common features of tax such as (I) it is a contribution whereby purchasing power is diverted from the hands of the people to the coffers of the State (ii) its proceeds are utilized for the common purpose and the taxpayers derived no direct benefit in paying taxes, (iii) the extent of the levy does not depend upon the benefits derived from government expenditure by the tax – payment; and (iv) its main object is to raise revenue for the government. Taxes, by one definition, are compulsory levies without a quid pro quo. Most governments have wide powers to levy and collect taxes. Yet, the nature, extent and distribution of these powers between the different branches of government have a variety of patterns. There are not relatively few works which treat this subject comprehensively nor are comparative descriptions of current country practice widely available.\textsuperscript{13} The benefits received by taxpayers from the government are not related or based upon there being taxpayers. A tax is a generalized exaction, which may be levied on one or more criteria upon individuals, groups of individuals, or other legal criteria. The distinction between tax and non-tax ravenous of the Government is not watertight there are some borderline cases which pertain to certain fees and charges levied in connection with a specific services or activity. Sometimes, it is difficult to distinguish between a fee and a tax.

2.3. History of Taxation

The fundamental proverb of public finance or taxation that has been recognized from times immemorial is, the governor should appropriate to itself a

\textsuperscript{11} Plank E.H, (with Collaboration of J W Jackson), PUBLIC FINANCE, Richard D.Irwin, 1953, p.126.
direct share in the produce of the earth. In the writings of history books, we find that the main source of Government revenue was a share of gross produce of all land varying according to the quality of earth and the amount of labour necessary to cultivate it. There were some other taxes revenues, for example "land-revenue", "Personal tax" is called (Capitation -tax), Animal tax, Sales tax is called (Enkyklion), Gift tax is called (Stephanikon) etc. Those taxes were imposed from time to time by governor during emergencies like war or famine, was also imposed for the purpose of storage in State granaries. Forced labour and occasional actions like "milk, money" were some of the other levies in those days.

The most comprehensive and detailed account of ancient taxes revenue system is found. The origin of taxation can traced to primitive civilizations. It was there that man first began to provide through government for services he could not provide himself. And it was there that he began his long and sometimes tragic search for the means to pay their cost. A wide variety of the tax technique has been developed. Taxes and the social structure on which they were imposed have undergone change through time. Yet the goals to which men aspire remain largely unchanged.

People search today, as they did in the past, for means that are just without being harsh, and for methods of obtaining maximum service at minimum cost. In agreeing on objectives, however, people have always disputed the specifics. No one has yet found a method of neither taxing that is wholly satisfactory nor one that met with universal approval.

EGYPT

During the various reins of the Egyptian Pharaohs tax collectors were known as SCRIBES. During one period the scribes imposed a tax on cooking oil. To insure that citizens were not avoiding the cooking oil tax scribes would audit households to insure that appropriate amounts of cooking oil were consumed and that citizens were not using leavings generated by other cooking processes as a substitute for the taxed oil.

14 DR.Prof.Arize M. Alkharaj and Finance System at Caliphate of Al-Islamia, 1977,p-p.50-52.
15 Angrish,A.C, Direct Taxation of Agriculture in India ,1972, P. 4.
Yemen:--

All writers on Taxes, Public Finance, and Economics in Yemen unanimously do not give history of taxes history in Yemen. But, I found some information in the end history book; it mentions that there is some tax types imposed upon people during Fifth Century B.C. in QATABAN KINGDOM. Those taxes were called “Commodity tax, sales tax, property tax etc,” and those taxes were collected by official appointment by the KING.  

India:--

In India, land value revenue or land products have a very long and multifaceted history."In the Vedic period, there was individual ownership of land and compulsory levy called (Bali) was realized by the King or Chieftain from individual peasant proprietors. (Bali) was payable in kind as apart of gross agricultural produce. The great Epic, Mahabharat , mentions (Bali) to be one – sixth of the gross produce . The Buddhist works, Picturing early conditions of Fifth centuries B. C. Point out that the rights to land of the individual peasant proprietors were limited only by the demands of the State and tell a little more about the taxes on agricultural.  

18 ‘Tithes’ on raw produce were collected in kind at the barn doors or threshing floor. Thus, we observe, revenues which government imposed it on their people, it is revenue of land.

Greece:--

In times of war the Athenians imposed a tax referred to as eisphora. No one was exempt from the tax, which was used to pay for special wartime expenditures. The Greeks are one of the few societies that were able to rescind the tax once the emergency was over. When additional resources were gained by the war effort the resources were used to refund the tax. Athenians imposed a monthly poll tax on foreigners, people who did not have both an Athenian Mother and Father, of one drachma for men and a half drachma for women.

The earliest taxes in Rome were customs duties on imports and exports called. Caesar Augustus was considering by many to be the most brilliant tax strategist of the Roman Empire. During his reign as "First Citizen" the publicani were virtually eliminated as tax collectors for the central government. During this period cities were given the responsibility for collecting taxes. Caesar Augustus instituted an inheritance tax to provide retirement funds for the military. The tax was 5 percent on all inheritances except gifts to children and spouses. The English and Dutch referred to the inheritance tax of Augustus in developing their own inheritance taxes.

During the time of Julius Caesar a 1% sales tax was imposed. During the time of Caesar Augustus the sales tax was 4% for slaves and 1% for everything else. Saint Matthew was a publican (tax collector) from Capernaum during Caesar Augustus reign. He was not of the old publicani but hired by the local government to collect taxes. In 60 A.D. Boadicea, queen of East Anglia led a revolt that can be attributed to corrupt tax collectors in the British Isles. Her revolt allegedly killed all Roman soldiers within 100 miles; seized London; and it is said that over 80,000 people were killed during the revolt. The Queen was able to raise an army of 230,000. The revolt was crushed by Emperor Nero and resulted in the appointment of new administrators for the British Isles.

In the tax world, there is almost nothing new through the centuries. Man has tried a vast variety of ways to raise revenue, and almost every age tax has its ancient counterpart. Not all of the attempts have produced the desired revenues and not all of them have had noble purpose. Some taxes have been bizarre, some brutal.

Viewing the means used to collect revenue today, modern man can take comfort from the fact that on tax problems, all men are brethren. If he fined tax burdensome, so did the Egyptian. If his car is taxed, so was the Roman’s chariot. If excise add to the cost of his cigarettes, they have done some to the Englishman’s tea and the Frenchman’s wine. In the annals of taxation, few articles have escaped notice. Taxes once were directed only at the output of a

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19 Http://www.taxworld.org/TaxHistory.htm (1of5)4/21/1999
man's labour, at the products of his land, or his craft. But the search for added revenue quickly pressed further a field, and some of the resultant tax criteria were strange indeed. Taking the fact of possession as evidence of ability to pay, rules have taxed wigs and windows, heaths and headstones.

In the 17th century in Holland, for example, a widow tax was levied and was made proportional to the degree of penetration; which produced architecture notably short of windows, light and air. In India, till very recently "special taxes were imposed by ruler of the smaller states in some of which whenever the ruler wished, for instance, to purchase a motor-car, a tax would be imposed on the people for the purpose. Similarly, taxes were levied to meet the expenses of marriages in the ruling families". 20

2.4. Characteristics of Taxation

Characteristics of a good taxation system may be formulated from various objectives. Discussion in the previous sections clearly indicates that these also form an integral part of its features.21 Important of domestic savings in developing economies do well known –domestic savings comprise Government and non-Government savings. Government savings are defined as budget balance on revenue account, which means an excess of revenue, receipts over revenue expenditure. Non-Government savings, consisting of household savings, and business savings, accounting for a major share of total savings.22

Do taxes discourage private savings and investment? Not necessarily. As regards income tax, provisions exist in the laws of most countries for the exemption of savings and investments from tax liability. Further more many believe that corporation tax is shifted on to consumers, and if this is so, producers are not discouraged to save and invest.

Taxes and their transactions discourage wasting expenditure and speculative business. Moreover, rates of income tax. Even if it is assumed that

20 V. P Menon – The Story of Integration of The Indian State, p 479.
22 Khasawena J. S. Public Finance and Tax Legislation, preceding source , p.97.
taxes discourage private sector and investments this loss can be compensated by increased public investment made possible through taxes.

Tax systems are not enacted to ensure that equally situated individuals are treated the same, or to provide incentives to encourage appropriate economic or social behavior, or to make life simpler for people. The fairest, most neutral, and simplest tax system would be no tax system at all. The purpose of the tax system is to assist the government in achieving its broad objectives. However, once it is conceded that a tax system is required for these purposes, and then it clearly should be designed in a way that satisfies the familiar criteria of a good tax system: equity, neutrality, and simplicity. The question addressed in this section of the paper is, having decided that an income tax base premised on the theory of control will make the income tax a more effective policy instrument in achieving the government's broad objectives of raising revenue fairly and achieving an acceptable distribution of income, do the traditional tax policy criteria of equity, neutrality, and simplicity suggest the control theory should be modified, or a base premised on the benefit theory adopted? The short answer is no. Indeed, each of these criteria supports the case for defining income based upon the taxpayer's control over economic resources. A good tax system recognizes that the taxpayer has some basic rights. He is expected to pay his taxes but not undergo harassment. With this end in view, tax laws should be simple in language and the tax liability should be determined with certainty. The mode and timings of payment should suit the convenience of the taxpayer to the extent possible. At the same time, a tax system should be equitable between different taxpayers. It should be progressive so as to levy an equitable burden on all. The main characteristics of tax are as follows: 23

1. Tax is compulsory payment: payment of taxes is compulsory if the taxpayer has attained the conditions, which are given in the relevant law as the sufficient conditions for the imposition of a tax. Thus, taxes are compulsory to be paid under certain conditions only. For example, one may refrain from paying sales tax on tobacco if he does not smoke; in the same way he can refrain from paying fine, if he does not commit any crime. In this way, payment of taxes is compulsory in a specified sense only. In the words of Buehler, “Tax is a compulsory contribution although it can be paid voluntarily.”

2. Tax is a payment to the Government by the people: if people among themselves or from government make payments to the people, they are not taxes. This implies, the taxes are imposed on by authoritative institutions and under such institutions we can take here none except the Government. If the management trust of a temple makes it compulsory for every year, it is never a tax. So taxes are payments by public to the Government only.

3. Element of sacrifice: Element of sacrifice is there in the payment of a tax in addition to the legal compulsion. We are also legally bound to pay the prices of provision which we buy but it is a mere commercial transaction and we pay price because we have to do but in cases of taxes at least in theory a sense of sacrifice is there as the tax payers pays the taxes for public interest. This is somewhat far-fetched idea and is practically found under the system of enlightened democracy and citizenship.

4. The aim of tax collection is public welfare: it is for the benefit of the general public and for the maximum welfare of the entire community that the taxes are levied and collected. The use of taxes in the welfare of vested individual interests or for the general public is not permissible. Tax-revenue is spent talking in view the aggregate welfare of the society and not of a particular section of it.

5. The benefit received is not directly the return of tax: Although a person may receive benefits accruing from the expenditure of the funds of which his contribution in the form of taxes constitutes a part, yet it is not intended or guaranteed by the State to give these benefits to a particular person in return of and in proportion to the payment he has made in the form of taxes.
6. Tax is not the cost of the benefit: Tax is not the cost of the benefit conferred by the Government on the public. Benefits and taxes are independent of each other. Payment of taxation is, of course, designed for the conferring of benefits on general public but is never collected as deemed as the cost of the benefit to be so conferred. A tax has no relation with the cost of service that a Government renders to an individual. According to De Marco, “the tax is the price which each citizen pays to the state to cover his share of the cost of general public services, which he will consumer”.

7. Taxes are paid out of income: taxes are paid out of income though they may be saving a part out of income. In the words of Dalton, “distinction between taxes assessed on income and capital respectively is often confused with the quite separate distinction between taxes paid out of income and capital receptively. But a tax assessed on capital may be paid out of income, and conversely. A man liable to death duties may pay them out of income, a man may self securities or borrow from his bank in order to pay income tax.” Hence the distinction has no importance.

8. The persons pay taxes: an individual pays taxes though they may be levied upon individuals or property or commodities. To pay tax is the personal responsibility of an individual as the possession, which he has and on which taxes are levied cannot pay tax. All taxes are paid by individuals and not by the goods or properties on which they are levied.

9. Tax is a legal provision: it is only after the levy of a tax becomes an act of the Government that taxes are levied. As has already been pointed out in the first point above, it is the authority of state that can impose taxes. Taxes become legal provisions, their collection is legal and person failing to pay them is liable to legal punishment. Though not an economic one, yet it is an element of a tax.

10. Different kinds of tax: A tax may be of different kinds, such, as income tax, sales tax, wealth tax, entertainment tax, property tax, water tax, house tax Act.

We may conclude that a tax is compulsory, which can be imposed only by the Government and non-else. It is collected for the general welfare of the society and hence a tax- payer has no right to expect a direct return of the amount of tax paid by him. Benefit, thus, cannot be the basis of payment of tax by any person.

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2.5. Taxation Canons

All writers on taxes, public finance and economics, from Adam Smith onwards, have attempted to describe the features of a good tax system. What constitutes a sound tax system will actually depend upon the nature of public expenditure and the people's ideas on the role of the government? What were ones considered as the most important function of the government may now be considered as only one among many functions? What are then the objectives of taxation in a modern economy? The taxation is one of the major sources of Government revenue. At the same time it has got a special role to play in redistribution of income and reduction in inequalities of income prevailing in the society. To achieve both these objectives, the taxation system should be such that it is acceptable to general public, fair to all members of society, simple to operate and capable of yielding the optimum revenue. Adam Smith, the famous eighteenth Century British Economist, was the first to set forth such maxims in his book (WEALTH OF NATIONS) published in 1776.24 The well-known economist laid down the four basic canons of taxation on which a good tax system should be based-Various economists also have suggested different canons of a good tax system.

Adam Smith Canon's of Taxation 25
1. The canon of equity/ability 2. The canon of certainty
3. The canon of convenience 4. The canon of economy

1-The Canon of Equity: 26

According to the first canon, which is also called as canon of ability, all citizens of the nation should contribute towards expenses of the Government "as nearly as possible in proportion to their respective abilities." 27 In other words, the
tax system should be such that the citizens are liable to pay taxes as per individual capacity to pay. The riches are expected to pay more while the poors are expected to pay less. The ability-to-pay taxes increases with the rise in income, thus making the higher economic class to contribute more to the Government revenue. This principle is based on the simple theory that the ability to pay taxes increases more than proportionately to the increase in the income because the utility of money gradually diminishes with every increase in the income.

The canon of ability is also recognized as a canon of equity as it calls for equal tax burden for all persons who are similarly situated in the economic income class. The basic principle underlying here is that “equals should be treated equally”. This principle makes a tax system “fair and just”. Thus, equity consideration is of overriding importance for any tax system and for any particular tax. Equity level determines now the tax burden is distributed among the taxpayers. Modern economists, however, did not agree to this opinion. Instead, they strongly put forth ‘progressive’ tax system which means increasing rates of taxes with the increase in income i.e., as the income rises, there is a lesser satisfaction to a person earning it and hence, a greatest part of that rising income should go to the government. This will enable the government to spend the funds for the welfare of those who are unable to earn rising income.

Considerations of fundamental fairness provide the main rationale for taxing income taxes. These considerations embrace both of the traditional tax equity criteria: horizontal equity, the need for equal treatment of persons with comparable abilities to pay; and vertical equity, the need for appropriate differences in the tax treatment of persons with different taxable capacities.

- **Horizontal equity**  It is generally agreed that the taxes imposed on an individual should bear some relationship with taxpayer’s economic capacity: a person’s taxes should correspond with ability to pay. In theory, the rate structure adopted should reflect the general consensus on the ability of a taxpayer with any given amount of income to bear
taxation. If ability-to-pay were determined by income level, two persons with identical incomes would be liable for the same taxes.

Vertical Equity. The vertical equity norm and idea of a graduated tax system underlies our entire tax system. But while it enjoys almost universal support, the justification for such a system is at best hazy. Few persons dispute Adam Smith’s assertion that taxes should be levied on an ability-to-pay basis, but none have been able to show why ability-to-pay should be measured on a progressive instead of proportional scale. Those who have attempted to devise an objective rationale for the system usually seek to demonstrate that progression in fact amounts to equality as results of the diminishing utility of money.

2-The Canon of Certainty: 28

Like canon of equity, Adam Smith advocated canon of certainty. This canon is meant to protect the taxpayers from unnecessary harassment by the ‘tax officials’ the tax which each individual is bound to by pay, ought to be certain and not arbitrary. Thus, the amount of tax, the time of payment, the method of payment, the place of payment, and the authority to whom the tax is to be paid. Must be clear to the taxpayer and to other persons- otherwise, the taxpayer shall be at the mercy of the tax administrators who may increase the tax rate as per their whims and fancies. This may put the public into greater degree of inconvenience and this may encourage corruption in administration. Certainty about tax liability helps a taxpayer to affect necessary co-ordination between his income and expenditure with a view to discharge his tax obligation with planning. 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 all to be clear and plain to the contribution and to every person.” 29 This canon of certainty was mainly advocated to prevent exploitation

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of taxpayers by the authorities collecting taxes. If the taxation policies are arbitrary and full of doubts and confusion, the possibility of harassment to the taxpayer by the collecting authorities by using their power cannot be ruled out. To avoid such a situation, the taxation policies should be very clear and should create confidence in the minds of taxpayers that tax being collected from them is just a proper.

3-The Canon Convenience: 30

The third canon of taxation advocated by Adam Smith is the canon of convenience. In the words of Adam Smith “every tax ought to be levied at the time, in the manner, it is most likely to be convenient for the contributor to pay it”. The tax should be levied at such a manner that its payment should cause least hardship or inconvenience to the taxpayer. For example, when land revenue is collected from a farmer after harvesting season, it is quite easy for him to pay the tax put if its collected before harvesting season, it is most trouble-some inconvenient to him. Similarly, sales tax. Excise duty or taxes on commodities satisfy the canon of convenience. Income tax also satisfies this canon because the salaried employees in monthly installments pay it. In short tax system should be such that its enforcement is certain.

4-The Canon of Economy: 31

Every tax involves some revenue yield and a corresponding cost of collection. Adam Smith noted, “Every tax to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the government.”32 The tax system should be economical to operate and the tax should be such that the cost of its collection


should be minimum. The revenue form tax should be much more than the cost of its collection. Otherwise the major portion of revenue will be taken away by the cost of its collection. This is particularly important from the point of view that the costs spent on the collection and nothing to the national output and resources, which are already in scarcity, should not be wasted. A heavy tax burden also does not satisfy the canon of economy. Thus, it is interpreted that if a tax is quite heavy reducing savings of the public, reducing investments and, thus, the productive capacity, the tax system seems to have failed to satisfy this canon. The people should not feel that the tax is excessive.

II-Other Canons of Taxation

5. Canon of Simplicity
6. Canon of Elasticity
7. Canon of Productivity
8. Canon of Co-ordination
9. Canon of Variety
10. Canon of Expediency

In addition to the above basic fundamentals of tax system, given by Adam Smith, some others writers like Bastable, Shirras, Mrs. Hicks etc. Have added a few more canons of taxation, which are as follows.

5-Canon of Simplicity

The good tax system should be simplicity so that taxpayers are understood that system and it should not be too complicated. That makes it difficult to understand and administer and breeds problems of interpretation and legal disputed. The tax policy should be simple and to the point. The better tax policy is the simple one which requires fewer conditions or assumptions. The canon is meant to prevent harassment to taxpayers and corruption among the staff of tax administration. The tax system must be easy to operate. A sound tax system should be simple and should not be too complex. Simplicity requires that a tax


34 Dr. Kulkami M, and others Business Taxation and Auditing, preceding source, 2001, p.5. Also see Bhatia H.L, Public Finance, preceding source, 23rd 2002, p.43. Also see AL-Rubeidi M. A. Tax Accounting, preceding source, p 52. Also see Dr.Tyagi B.P, Public Finance, preceding source, p.111 . And Lekhi R.K, Public Finance, preceding source, p.167. Also see Agarwal R.C, Public Finance, preceding source, p 69.
system not impose under burdens of administration and compliance through complex and costly rules record-keeping. Administration survey indicates that most taxpayers make other uses of information gathered to file the State portion of their State tax return.

6-Canon of Elasticity:

The tax system should be adaptable to changing circumstances. It should not be rigid or inelastic. The tax system is expected to provide built-in devices to facilitate growth and expansion without dissatisfaction. The tax system should be flexible so that taxes may be increased or decreased as per the needs of the government. Thus, income tax rates may be revised upwards or downwards as per the requirements of the government from time to time. Similarly, the government of India announced rise in petrol duty in order to cope with the oil crisis in the country. It should be possible for the authorities, without any delay to revise the tax structure, both with respect to its coverage and rates and to suit the changing requirements of the economy and of the treasury.

7-Canon of Productivity:

Productivity has become a key issue with tax planners. Economic growth has come to be firmly linked with gains in productivity. The canon of productivity requires that the taxes imposed by the State provide sufficient revenue so that the government may not be required to face financial difficulties. Thus, a tax system should be capable of providing adequate revenue to the State to enable it to perform its function satisfactorily. The tax system should help to increase productivity in the economic sectors.

8-Canon of Co-ordination:

Co-ordination aims at higher efficiency and effectiveness. Co-ordination brings about integration. Co-ordination expresses the principle of organization in

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35 Dr. Kulkarni M, and others Business Taxation and Auditing, preceding source, 2001 p .5. Also see Bhatia. H.L. Public Finance, preceding source, 23rd 2002, p.42. Also see Dr.Tyagi B.P. Public Finance, preceding source, p.110. And Lekhi. R.K. Public Finance, preceding source, p.166. Also see Agarwal .R.C, Public Finance, preceding source, p. 69.


total, nothing less. Co-ordination is orderly arrangement of group efforts to provide unity of action in the pursuit of common purpose. It is essential to secure maximum co-ordination between different taxes imposed by different governments. The Constitution of India provides various guidelines in respect of taxation by various governments in order to avoid any conflict or dispute between the Central Government and the State Governments. This ensures maximum co-ordination. Any Government should not encroach upon the rights of other Government in matter of taxation.

9-Canon of variety/Diversity: 38

Under diversification a multiple tax system is preferable. A government, which adopts variety or diversity as a growth plan, seeks to enter into new tax system and process. According to this canon, a multiple tax system should be preferred instead of single tax system. A single tax system is one where under only one tax be levied upon a person i.e. he is to pay to the State only one tax, thereby the Government collects all that a person has to pay to the state. This will enable the state to distribute burden of taxation on every section of the society. Such a system is bound to breed a lot of uncertainty for the treasury. It is also likely to be inequitable as between different sections of the society. On the other hand, if the tax revenue comes from diversified sources, then any reduction in tax revenue on account of any one cause is bound to be very small.

10-Canon of Expediency: 39

According to this canon, a tax should be such that it requires no justification and it should not be a subject of any criticism. Thus, it should not be baseless. As far as possible, this canon of expediency should push its revenue by increasing the existing rates. This canon has got much importance, particularly in democratic countries.

The above canons are general guidelines, which characterize good tax system. In addition to these canons, another important element of sound tax

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system is that it should help the government to check the inflationary trends. A sound tax system should, therefore, ensure the attainment of equality in incomes, wealth and opportunities.

2.6. Theories (Principles) of Taxation

According to Adam Smith the classical economists advocated a free market economy and minimum interference of government in economic matters. And it should perform only three functions, viz., justice administration, defence, and the duty of erecting and maintaining certain public works and institutions. 40 Later Sir Henry Parnell stated "Every particle of expenditure beyond what necessity absolutely requires, for the preservation of order and for protection against foreign attack is waste and an unjust and oppressive imposition on the public" 41

Despite all writers on taxation, public finance and economics unanimously hold the view that the system of taxation should be based on the principle of equality. If the payment of taxes is considered as a burden it might seem that the simplest way of its distribution would be to make each member of community to make an equal contribution. But in modern society such a system of taxation would be obviously unfit and ridiculous, as the rich have to pay a small and the poor a large percentage of their respective income. This may not only adversely affect the poor economically but morally and socially as well, thus, wherever the inequality of wealth exists, taxation should be according to one’s ability to pay. Several theories have been advanced from time to time for achieving the principle of justice in taxation. The main principles / theories of taxation are as follows:

2.6.1. The physiocratic theory/ principle:

The physiocratic theory is the oldest and simplest theory of taxation, which was propounded by earlier economists. This theory had its origin in finance. This theory is based on the view that only land is capable of producing a net surplus. Thus, according to physiocrats only agriculture is capable of yielding a net return, which could add to the wealth of the country. Therefore, the revenue of the state

41 Bishnoi, Usha. Union Taxes in India, 1980,Inough publication, 2 - Strachey Road, India, p-p.4-12.
should be derived by means of single tax levied upon land. But there are some important pitfalls that have been recorded below:

Chart 2.1 Theoretical of Taxation

Source: Agarwal R.C. Public Finance, Theory & Practice, P.91

It is wrong to assume that only land is productivity, which can yield net return. On the contrary, the industries are more productive and they can yield higher net return as compared to land. Land revenue is not sufficient to meet the large expenditure of a modern government. This principle leads to unjust and unfair distribution of a tax burden. Undoubtedly, it is against the canon of ability.

\[\text{Source: Agarwal R.C. Public Finance, Theory & Practice, P.91}\]

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\[\text{Agarwal R.C. Public Finance, Theory & Practice, preceding source, P.92. Also see Tyagi B.P, Public Finance preceding source p.118. And Lekhi R.K, Public Finance, preceding source, p.169.}\]
2.6.2. Finance principle/ theory of taxation

According to Calbert (Finance Minster of France), “pluck the goose with as little squeaking as possible.” It means that the tax should be imposed in such a way that the Government has to face minimum resistance (opposition) from the public on one side and the government collects maximum amount of revenue on other side. The main object is to maximum the collection of revenue rather than distribution of burden of taxation. The greatest danger in following this theory is that the burden of taxes may fall mainly on poor, weak and voiceless people of the society rather than on rich people. Hence, this theory has been rejected by most of the economists in principle, as it has no place in a modern welfare state. That is why; this theory has lost its utility and has got no practical importance.

2.6.3- Benefit principle/theory of taxation

According to this principle, the burden of taxation should fall on the people according to the benefit received by them from the state. Every citizen should be called upon to pay the taxes in proportion to the benefits derived by him from the services rendered by the government. The idea behind this principle is this that the public pays taxes in the form of return of the benefits conferred upon them by the government. The principle naturally proclaims the justice of do not take that to give. In other words, the collective payment of taxes by the public hold not exceeds the value of benefits conferred upon them by the government. It is for the collective benefit that the taxes are levied, not for the individual benefit. The benefit approach has two implications: firstly, benefit is used as a justification for taxation and secondly, it serves as a standard for apportioning tax burdens.

According to the benefit theory, taxes should be apportioned among people in relation to the benefit they receive from publicly provided goods and services. Under the benefit principle, horizontal equity requires that people who enjoy the same level of benefit pay the same amount of taxes. Vertical equity will be achieved if those who enjoy more of the services pay more in taxes than those who enjoy less. Of course, according to this theory, those who make no use of

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44 Agarwal R.C. Public Finance, Theory & Practice preceding source, p.p 92-93. Also see Tyagi B.P, Public Finance, preceding source, p.120.
the services should be free of the taxes needed to provide it. The benefit principle will be pleasing to those who feel comfortable with the idea that you should pay for what you receive. Such people do not wish to have others subsidize their activities. 45 The benefits-received approach has a long-dated origin and its roots lie in the contract theory of the State. Professor Edwin R. Seligman surveys the development of this theory as contributed by various authors and thinkers. The theory was vogue with German, French and other writers like Grotius, Hobbes, Locke, Hume and Rousseau. According to this general approach, the main theme was that the subjects of a country had a contact with the State for the protection of their lives and property to which end the State was providing various goods and services.

According to this theory, the burden of tax must be imposed in proportion to the benefit received by a taxpayer person from the expenditure incurred by the Government financed from tax receipts. To use J.S. mill’s terminology, the relationship between the taxpayer and the State runs in quid pro quo terms. It is basically an exchange relationship. In this theory, the problem of reducing the income inequalities has been ignored. This approach does not also consider the possible use of the tax policy for achieving economic growth or economic stability in the country. The theory considers only the way in which the goods and services should be supplied and financed by the government and the private sector. 46

2.6.4- Cost of service principle/theory

This is one of the oldest principles advocated by earlier economists for the distribution of the tax burden. According to this principle/theory, the government should tax the citizens in accordance with the cost of the services rendered by it. As a matter of fact, the Government renders several types of services to the citizens. According to this principle, the citizens should be taxed by the government while keeping in mind the total cost incurred on the provision of these services. Each taxpayer has higher the cost, the higher should be the tax rate and vice versa. According to A.C Buethler, “various writers have suggested

that the taxes should be priced or rates paid for the services rendered to each person by government according to the cost incurred perhaps with the implication that the citizen should be allowed to select or eject Government service at their volition." Thus, those persons who do not use the services provided by the state should not be required to pay any tax. According to this principle, the tax is equal to price, i.e., if you purchase anything from the market you should pay for it. In the words of Dalton, "the cost of service can be applied to the supply of postal services and electric current etc. by the public authorities and the price of such services can be fixed in according to this principle." 47

2.6.5 -Ability to pay principle/theory

The ability -to-pay principle focuses attention completely on the tax side of the public sector. The assumption is that the expenditure side of the budget has been determined through political and economic processes. The job now is to design an administrable tax system with the proper mix of equity and efficiency. 46 Horizontal equity requires that people with equal ability to bay be subjected to the same tax liability. Vertical equity is generally interpreted to mean that people with greater ability will pay higher taxes than those with lower ability. This approach considers the tax liability in its true form - a compulsory payment to the government without quid pro quo. It does not assume any commercial or semi-commercial relationship between the Government and citizens. According to this approach, a citizen is to pay taxes just become he can, and his relative share in the total tax burden is to be determent by his relative paying capacity. 49 The ability to pay approach is based on the broad assumption that those who possess income or wealth should contribute to the support of public functions according to their relative abilities. The idea of a just- has been associated with the earliest concept of ability to pay. According to this principle, every citizen should pay the tax to meet the cost of Government expenditure according to his ability to pay. If every citizen pays the taxes according to his ability to pay, such a system of taxation would be an ideal system. Ability is the ideal ethical basis of taxation.

47 Agarwal R. C, Public Finance, Theory & Practice, preceding source, p. 95. Also see Tyagi B.P, Public Finance, preceding source p.121. Also see Lekhi R.K, Public Finance, preceding source p.170. Also see Bhatia H.L, Public Finance, preceding source, p 69.
Modern conception of the state. According to Cohn, it is but a special application of the broad principles of moral solidarity.\textsuperscript{50}

Implementing the ability-to-pay principle obviously requires us to define what we mean by taxpaying ability and to determine just how much more people with greater ability must pay than those deemed to have lesser ability. Defining ability to pay, or what might better be called "fiscal capacity," is matter on which there exist important differences of opinion. However, we can move on by recognizing that for many, if not most people able to pay or personal fiscal capacity is best measured by income.

Attempts at being more specific about designing a tax structure based on ability to pay have been carried out by focusing on the nature of sacrifice involved in paying taxes. At the other extreme is the idea that the tax system should be designed to create the minimum aggregate sacrifice for the group as a whole. In each system sacrifice due to taxation is determined with reference to marginal utility of income function such as the one illustrated in table 2.1. Marginal utility of income is defined as the welfare or satisfaction associated with each extra dollar of income the first few dollars of income provide life-preserving food; later dollars are used for the luxuries of life. To apply the sacrifice notion, we must assume that all people's welfare can be described by exactly the same marginal utility curve. Our first criterion, equal absolute sacrifice, means that all people should experience the same loss in welfare in their support of the public sector. The nature of tax and the relative tax ability under the three sacrifice approaches of subjective approach are summarized in the table given below.\textsuperscript{51}

<table>
<thead>
<tr>
<th>Table 2.1 the Nature of Tax and the Relative Tax Ability</th>
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<tr>
<td>Concepts of sacrifice</td>
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<tr>
<td>1- Equal absolute sacrifice</td>
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\textsuperscript{50} Agarwal R.C. Public Finance "Theory & Practice", preceding source .p. 96.
\textsuperscript{51} Tyagi B.P. Public Finance, preceding source .p.137.
2- Equal proportional sacrifice

<table>
<thead>
<tr>
<th>More progressive than equal</th>
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<tbody>
<tr>
<td>Higher</td>
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<td>Lower</td>
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3- Equal marginal sacrifice

<table>
<thead>
<tr>
<th>Highly progressive taxation (with tax exemption for law income group)</th>
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<tbody>
<tr>
<td>Highest</td>
</tr>
<tr>
<td>Lowest</td>
</tr>
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</table>

2.6.6-Equity principle/theory

Equity principle is the most important principle of taxation. Modern writers have laid a great emphasis on justice and advocated following of the principle of equity in matter of distribution of burden of taxation. Equity generally means fairness or justice in the distribution of burden of taxation. It means that the burden of taxation is spread more or less uniformly on equity basis among the taxpayers. This has two implications:

- The people should be treated in a like manner or those who are essentially equals should be treated equally. It is also called horizontal equity. Persons in similar circumstances should be treated equally. It is also called horizontal equity. Persons in similar circumstances should be treated equally. For example, people with equal levels of income should be taxed at the same rate. They should sacrifice the same proportion of their incomes as tax. To obtain horizontal equity, taxpayers with equal ability to pay should contribution equally. The principle of horizontal equity thus demands that equals should be taxed equally.

- Unlike people should be treated in an unlike manner or unequal should be treated unequally. The persons who are better off should pay more taxes than others. This is called vertical equity. For example, people with unequal incomes should be taxed at different rates of taxation. Those with a higher level of income, should be made to pay comparatively a higher proportion of their income, i.e. a higher rate of tax be imposed on them. Thus the principle of vertical equity demands that unequal should be treated unequally. However, as Paul Samuelson points out, general and

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52 Agarwal R. C. Public Finance, Theory & Practice preceding source p. 98. Also, at same meaning the arguments taxation theories see Lekhi R.K., Public Finance, preceding source p. 174.
abstract principles of taxation cannot resolve the fundamental political question of how differently unequal should be treated or how we are to define equity. Nevertheless, various economists have evolved different principles of taxation to establish horizontal and vertical equity.

2.6.7 - Least aggregate sacrifice principle/theory

Well-known economists like Edge worth, Pigou, Dalton and canon have supported the principle of least aggregate sacrifice. According to them the least aggregate sacrifice is the final principle of taxation. The principle is just an advancement of the ability theory and takes the sacrifice or disutility in the collective way for the whole body of taxpayers. According to this principle, the government should devise its taxation system in such a manner that the aggregate sacrifice by all the citizens should be the minimum. The principle states that the taxes should be allocated in such a manner that the sacrifice incurred by the persons paying taxes taken collectively would be the least. Hence it is not essential that all the persons be subjected to taxation, but on the contrary, the government should fix a minimum exemption limit. The tax should be levied at progressive rates only on those persons whose income exceeds is lower than that of the poorer sections. Hence, the richer sections make less sacrifice than the poorer sections while paying taxes to the government. In case of the poorer sections are exempted from payment of tax and thus the entire amount is collected from richer sections, the aggregate sacrifice involved shall be the minimum. Prof. Pigou supports this principle because the least aggregate sacrifice is an essential prerequisite for maximizing economic welfare.53

2.6.8. Theory / Principle of Neutrality

According to this principle of neutrality tax be levied on different persons in such a way that the economic position of the taxpayer remains neutral and the inequality of income is not affected. According to prof. A.C. Pigou, “The function of the state is simply to realize tax and remain neutral towards reducing of inequalities of income.” He has called this principle of neutrality as leave them as

you found them the theory of neutrality suggests including the principles of equal sacrifice, proportional sacrifice and minimum sacrifice. 54

2.6.9. The socio- Political theory

Adolph Wagner advocated that social and political objectives should be the deciding factors in choosing taxes. Wagner wanted that each economic problem should be looked at in its social and political context and appropriate solution found thereof. The society consisted of individuals, but was more than the sum total of its individual members. 55

It is important to note that a unique weighting of these factor can be applied in making an overall judgment of the system, each factors looked at individually is a necessary but not sufficient condition for tax system to be judged good. A tax that distracts or discourages economic activity or stunts the growth of the economy is self-defeating, and a tax, no matter what are other qualities, that is deemed unfair will not be tolerated.

From time to time, however, we become somewhat more concerned with one of the features. During prosperous times and times when be economy is experiencing healthy rate of growth, equity becomes the prime concern. Currently, however, we are experiencing a sluggish economy, and it is both natural and predictable that people’s attention should shift toward greater concern with the equity and efficiency, but it must be recognized that there exists no simple and precise formula with which to make such a measurement.

Before we get into the specifics of tax analysis, we would like to point that our judgment is sometimes directed toward the tax system as a whole. Both concerns are important. Each particular tax must be judged on its own merits. It may have some particularly desirable of one tax may be offset by that of another tax. In the end, it is our judgment of the system as a whole that is most important.

A tax must also be judged on economic effects. The imposition of a tax is likely to affect behavioral patterns. People will try to avoid the tax. If a tax is placed on the consumption of product and the has effect of rising the price of that product, there will certainly be a tendency for people to shift their consumption to

54 Agarwal R. C. Public Finance, “Theory & Practice”, preceding source p. 100 .
competing well. This may prevent the economy from growing at an acceptable rate and may, therefore, turn out to be a factor that outweighs other qualities (like the equity of the tax) that than rate structure might exhibit.56

2.7- Purpose of Income Tax:

Tax revenue is treated as one of the most important may be of raising the funds for government activities. Apart from rising of funds, the tax policies are being framed to achieve several economic and social objectives. The primary function of most taxes is to divert economic potential from the private sector to the government for its use. The state can employ any number of methods to appropriate private wealth to public purposes; the choice of tax system should ultimately turn on the aims of the government expenditure programs in which taxation dollars will be spent.

Before determining the immediate goal of government expenditure, it is appropriate to pose a more fundamental question: why do we need a government to appropriate private wealth to public purposes only because it understands that a government and public expenditures fulfill necessary social functions that individual citizen operating in an unrestrained free market will not be able to provide. The objectives of the 'Income Tax' in India may be summarized into the following broad headings:

2.7.1-The Equity Objective: 57 This takes into consideration the ability to pay. This implies that everybody should be taxed according to the income he earns. Equity and social justice demands that the rich people should bear a heavier burden of tax and the poor a lesser burden. This has been well achieved, as the income tax in India is highly progressive. As the income increases the burden of tax also increases.

Due to this progressive burden of tax the extra income accumulated with the rich class of the society is taken away by way of income tax and it is diverted to the necessary development schemes for the benefits of the poor class of the

57 Dr. Kulkarni M, and others Business Taxation and Auditing, precede source, 2001, p.13. Also see Dr. AL-Rubeidi, M. A. Tax Accounting, preceding source, p.47. Also see Anaamri A. Al-aly, Taxation System in Islamic. Preceding source p.117.
society, thus uplifting the economic level of the mass community. This assists in reducing the gap between rich and poor by curtailing the consumable surplus available in the hands of the rich. This redistribution of income is one of the most important roles played by the income tax in the world.

2.7.2 Revenue Mobilization Objective: The scope of raising of funds from income tax is limited. But tax policies adopted in our country is useful in mobilization the resources. The government is using income tax as one of the device to mobilize the resources. In spite of progressive rates of income tax the revenue realized through income tax is not significant because very few citizens are charged to income tax. By a rough estimate even a less than five per cent of the total population is not contributing to the tax realization. Due to this the share of income tax in the total government Revenue is less than ten percent of the total revenue. The income tax did have a prominent role in revenue mobilization in the past, but over the five-year plans its significance has gradually decreased.

In spite of above limitations of income tax in revenue mobilization, one cannot neglect it altogether. Income tax still assumes a definite position in the government revenue. Particularly, the corporate income tax is used still as a major tool to yield more and more revenue.

2.7.3 The Growth Objectives:

Income tax is being used as an important instrument of economic growth. It is aimed at to accelerate economic development. For this purpose tax policies are farmed in such manner that consumption of undersized expenditure is restricted and savings is increased. By employing the proper personal tax and corporate tax policies the investment in capital formation is encouraged. Exemption of tax and concession are provided in the Act to induce more and more investment in priority sectors of the economy, which in turn generates more income in those sectors. The allowance of depreciation and investment deposits provided in the Income tax Act is primarily meant for augmenting the capital base of the

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58 Dr. Kulkarni M, and others Business Taxation and Auditing, preceding source, 2001 p.14. Also see Dr. AL-Rubeidi, M. A, Tax Accounting, preceding source, p.45. Also see Amaoymi A. Al-aly, Taxation System in Islamic. Preceding source, p.117.

countries. So income tax Act is encouraged to the increase investment or savings in the long-term investments like provident funds, public provident funds, savings certificates etc. Sufficient savings and investments are needed for rapid economic growth. The present tax system in both countries does take for consideration this aspect.

2.7.4. Economic stabilization objectives:

The free markets system, operating without external public constrains, may operate more efficiently than any other economic system; unfortunately, it rarely operates consistently. It is subject to peak and through; periods of over employment, and, more often, underemployment; deflation and more often, inflation; revaluation and devaluation of the currency. The fluctuations of an unrestrained free market are inimical to both social and private interests.

Stabilizing these economic fluctuations is beyond the scope of the free market, and since the Great Depression, has become an increasingly important government responsibility. That the private sector supports government interference in the market, almost all segments of society likely to be hurt by a fluctuation in the wrong direction seem willing to forgo some current security in the hope that public expenditure will minimize the risk of future insecurity. Support for government intervention in this particular sphere no doubt stems from the realization by those with most to gain from a free market that they will benefit most in the long run from economic stability. Even the most compulsive gamblers are willing to pay some price to hedge their bets if that will minimize the loss of a fluctuation turn against their interests.

In carrying out its economic stability function, the government has many weapons in its arsenal, such as the ability to rise or lower interest rates, increase or decease the money supply, and so forth; it is not restricted to the single tool of public expenditure. This latter government function, however, is particularly important to tax theorists and tax advisors. Since federation and particularly since

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60 Dr. Kulkarni M, and others Business Taxation and Auditing, preceding source, 2001 p.14. Also see DR. AL-Rubeidi,M. A. Tax Accounting, preceding source, p.45. Also see Anoaymi A. Al-aly, Taxation System in Islamic, Preceding source, p.117.
the Second World War, manipulation of public expenditure and taxation levels have played a pivotal role in government’s attempts to stabilize economic growth.

2.7.5. To Attain Fairness Between People.\textsuperscript{61}

The income tax has been an important tool in the hand of government where it can achieve distribution of general expenditures in the society. Scarcity of real resources in developing countries calls for their optimum utilization. Since the composition of investment is an important determinant of growth rate of the economy, public policy must discourage the flow of resources to low priority areas so that they could be diverted to vital sectors of the economy. By imposing high tax rates on individual income, property income, gain and profit of business or professional. The government can discourage the consumption and production of such items ensuring in the process release of resources for high priority sectors. Conversely, offering tax concessions or even subsidies can encourage production of necessities of life and employment – oriented industries.

2.7.6. Redistribution of Income and Wealth.\textsuperscript{62}

In the absence of any government intervention, the distribution of wealth and economic capacity is unlikely to achieve any degree of equilibrium. Those with greater inherent talent, or with more training or luck, will acquire a great deal, and the disadvantaged little. We all recognize the truth in the old adage that money begets money, and if distribution were left to the free market alone, an ever-diminishing proportion of its citizens would hold an ever-increasing portion of the country’s wealth. Those who support government redistribution on a number of grounds. Some contend that the wealth distribution pattern that would emerge without government intervention is undesirable simply as a matter of fairness: it would be unfair if luck of birth and resulting distribution of talent or handicap, wealthy or poor parents and so on, should entitle some citizens to a life of wealth and condemn others to a life of hardship.

\textsuperscript{61} Dr. Kulkarni M, and others Business Taxation and Auditing, preceding source, 2001, p. 14. Also Dr. Prof. AL-Rubeidi, M. A, Tax Accounting, preceding source. p.47. Also see Anoaymi A. Al-aly, Taxation System in Islamic. Preceding source, p.117.

\textsuperscript{62} Dr. Kulkarni M, and others Business Taxation and Auditing, preceding source, 2001, p. 15. Also see Dr. AL-Rubeidi ,M. A ,Tax Accounting, preceding source ,p.47.
2.7.7. Promoting certain types of business activities.\textsuperscript{63}

Classical approach

The classical approach of taxation was that there should be a minimum amount of taxation. Hence, the utilization of tax was not studied at all. The consequence was that the taxes were regarded, without further ado, as being accompanied by contraction in the supply of available goods with all the mistaken consequence of this mistaken approach. The principle of taxation was that the task of public finance was simply to keep government expenditure to a minimum and to raise the funds for it by taxing the public in the least troublesome way. Ricardo stated, "If you want peaceful government, you must reduce the budget". The classical view was that every particle of expenditure beyond what necessity absolutely requires for the preservation of order and for protection against foreign attack was waste and an unjust oppressive imposition on the public. Historically, the idea that all taxes are evil stems from the facile individualistic doctrine and that, outside the narrow sphere of its tradition minimum of activities the state can do not right. This narrow concept of duties of the state satisfied the political thought and the economic instinct of the earlier times. Adam Smith, therefore, confined the scope of the government activities to i. defence, ii. Administration of justice and, iii. Certain public works. Fiscal policy was conceived to be a policy in regard to the budgetary operations of the government, that is how the expenditure of the government should be met by a tax system that puts least burden on the society by not disturbing the pricing system as far as possible, and leaving, in effect the relative distribution of income as it would have been in a tax-free society.\textsuperscript{64}

2.7.8. Allocation of resources:- \textsuperscript{65}

This aspect of taxation is concerned with the allocation of resources between, for example, private and public goods and between investment and consumption goods. It is also concerned with correcting deficiencies in the pricing mechanism due, for example, to monopoly elements, the existence of external

\textsuperscript{63} Dr. Kulkarni M. and others Business Taxation and Auditing, preceding source, 2001, p.15. Also see Bhatia H.L., Public Finance, preceding source, 23\textsuperscript{rd} 2002, p.42. Also see Dr.Tyagi B.P. Public Finance, preceding source, p.109. And Lekhi R.K., Public Finance, preceding source, 11\textsuperscript{th} 2003,p.165.

\textsuperscript{64} Smith Adam, The wealth of national, vo 1,2, 1921, book 4 chapter 1, part 1,2,3, p.p 209-241.

\textsuperscript{65} Tyagi B.P. Public Finance, preceding source, P.236.
economies or diseconomies, and cases where social costs diverge sharply from private costs.

2.7.9. Distribution of resources:

The distribution of income and wealth depends on a number of factors including work, educational opportunities, inheritance, gifts, government fiscal policy and legislation. The distribution heading is concerned with the adjustments that society decides to make in order to correct for deficiencies in the distribution of income and wealth.

1.8. The Impact of Taxation on the Economic Development

The classical economists, who believed in *laisser-faire* philosophy, held the opinion that the main objective of taxation was of a neural tax policy and not bringing any change in resources allocation pattern as determined by the free market mechanism. But, today, changed circumstances and ideologies, the motives of taxation have altogether changed. According to modern economists, its objective is not merely to earn income for the Government. The effects of taxation cover all the changes in the economy, resulting from the imposition of tax system. Government uses taxation not only for the purpose of raising money to carry on with the business of governance but also as an important fiscal tool for economic development. The fiscal policy of a country derives its meaning and direction from the aspiration and goals of the society within which it operates, of the people whom it serves the aspirations of the people of world. The pursuit of these objectives involves, in turn, acceptance of the following as economic objectives of tax policy:

A. To make available for economic development the maximum flow of the human and material resources consistent with minimum consumption requirement;
B. To maintain reasonable economic stability in the face of long–run inflationary pressure and short–run international price movement;

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C. To reduce, where they exist, the extreme inequalities in wealth, income and consumption standards which under-mine productive efficiency, offend justices and endanger political stability.

The role of fiscal policy has changed radically along with the change in the concept of government. The government today is on more a policy state assigned with the responsibility of protecting the community. It has an important role to play in the uplifting of the economy and paving the way to raise general standard of living. It has to provide public services and for that purpose it must have adequate resources. It also needs resources for financing development programmes. One of the primary means of financing all such programmes by the Government is taxation. Also tax policy plays an important role as one of as set of general policy instruments in furthering the achievement of the objectives of planning economic development. By and large the objectives of the tax policy of any country are more or less the same as those of the general economic policy of the country itself. The tax policy is essentially an instrument to attain the economic objectives that a nation has set before itself the clear context for the examination and evaluation of taxation policy, procedures and rates must, therefore, be the specification of the economic development. The objectives of tax policy reflect overall goals of planning development. We can explain, the approach about defining of impact of the taxation policies of economic development of any country, one is classical approach and modern approach. While many may consider the concept of functional finance as too extreme. It cannot be denied that in the last five or six decades fiscal policy has become an important instrument to influence the level of economic activity in a country. We may discuss the economic effects of taxation according to Dalton, under the following three headings: (1) Effects of taxation on production, (2) Effects of taxation on distribution, and (3) Other effects of taxation.

I -Effects of Taxation on Production

Dalton has pointed out that the size of national income and employment depends in a country upon three conditions:

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1. Ability to work and save.
(2) Willingness to work and save.
(3) Diversion of resources between industries and places.

Let us see briefly each one of these points.

1. **Effects of taxation on people's ability to work, save and invest**

   - **Ability to work.** Every unit of tax curtails the purchasing power of taxpayer and transfers in the hands of the governments. This results in the reduction of the taxpayer ability to acquire necessities. Since the poor section of the society uses most of the income in the purchase of necessities, the tax imposed on their income leaves them with a smaller amount of money. In other words, income taxes reduce the volume of income individuals and organization that have to transfer part of their money income to the Government by way of taxes. A person who pays a high percentage of this income to the government by way of income tax may find that he cannot afford the usual conveniences as well as education for his children- this means a reduction in his ability to work.

   - **Ability to save.** Besides, a progressive income tax reduces the ability to save also-as Keynes has pointed out; 'saving depends upon the level of income.' Therefore, by reducing income, saving also is reduced: Not only direct taxation, but also indirect taxation will also have similar effects on the ability to work and save.\(^{70}\) In other words, income tax reduces the net income of individual, which results reduction in the saving.

   - **Ability to invest.** Investment is a function of saving potential. The saving potential of people and the resources for investment are curtailed to the same extent with the increase in taxation. In other words, if tax reduces the net income of individual, who result reduction in the saving, also decrease investment volume.

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2. Effects on people's willingness to work and save the investment:71

While it is easy to demonstrate the adverse effect of taxation on ability to work and save, it is difficult to show the relation between taxation and incentives to work and invest (i.e., willingness to work and save). We will have to discuss the question under two headings: (a) what will be the reaction of individual to taxation, particularly high rates of direct taxation? And (b) how do business firms and entrepreneurs react to the imposition of high rates of taxes? The first question will be a discussion on the incentives to work while the second will be a discussion on the incentives to invest. Let us take one separately.

A - Incentives and individuals: - 72 In the case of an individual, a tax is paid out of the income earned. The anticipation of a tax and the necessity to pay it out of the given income may induce a person to work hard and earn more or maintain the same amount of work and get the same income but pay the tax out of savings. But it is very difficult to say off hand whether a man will work hard or will work less. To a certain extent, this will depend upon the psychology of the taxpayer and the nature and the rate of tax imposed. It is now universally recognized by writers that direct taxes, particularly income tax, have far greater adverse effect on incentives as compared to commodity taxes, which generally do not have any effect on incentives, or at least very little effect. This is so because, in the case of income tax, the taxpayer has to pay a certain amount directly to the government and, obviously, he will not be willing to work because part of the rewards for work will have to be paid out to the government or, he will continue to work hard and earn more money income but will attempt to hide it from the government and avoid paying the income tax.

B - Incentives and business units:- Let us now turn our attention to the second question of taxation on business firms and entrepreneurs and incentives to work and invest. It is necessary here to understand the whole set of influences which stimulate the entrepreneurs to undertake the risks and hazards of the market

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mechanism. The sprite of enterprise, the instinct for gambling, the ambition to create a business or industrial empire, the desire to accumulate a fortune, to gain a conspicuous position of power and prestige in society, to wield political power via economic strength, almost an religious fervor for hard work, austerity and accumulation of wealth and riches—these are some of the motive forces which influence incentives to work and invest. Western economists have recognized the desire for personal gain as the dominant motive behind the sprite of enterprise. High rates of taxation on the factors of production will obviously tend to raise the cost of production; if prices of finished goods remain the same, profits will decline and so will do the incentives and enterprise.

3. Taxation and Diversion of Economic Resources: While the volume of production and national income in a country depend upon the ability and willingness to work and save, the pattern of production depends upon the way economic and human resources are allocated. Accordingly, taxation can influence not only the size of production but also the pattern of production. Examples of beneficial diversion of resources between occupations and places as a result of taxation may be unfavorable. A tax on harmful drugs will raise the price of the drugs so much that demand will be curtailed considerably. Production of such goods will be discouraged and factors of production engaged in their manufacture will be gradually shifted to other industries. Again, tax concessions and exemptions on goods produced in a particularly backwards region can help divert economic resources employed in congested and over-crowded areas to backward regions. This will help in the opening up and development of backwards regions and also for the overall balanced development of all the regions.

II -Effects Of Taxation On Distribution On Income: Reduction in inequalities of income and wealth is one of the main objectives of modern welfare Government. Fiscal operation on modern time has constantly been recognized as the best means of achieving fair contribution of income and wealth in the

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economy. In order to bring about an equitable distribution, public expenditure may be incurred in such a way that it may lead to an increase in the income of the poor. The taxation may be so devised that it may curb the income and wealth of the rich. Taxation, thus, is an important tool to narrow down the gap of disparity in income and wealth existing in the society. On the contrary, modern economists treat taxation as the powerful instrument for bringing out a reduction in the equalities of income and wealth. The disparity of income is hidden behind class conflicts. If the object of the government expenditure is to reduce the disparities of income and wealth then the same object is also of taxation. The effect of taxation on the distribution of income and wealth among the different sections of the society may be studied under two headings:

1- Nature of Taxation. The nature of taxation implies as to how the burden of taxation is distributed amongst the different sections of the society. A tax may be proportional, progressive and regressive in nature. We have to look at the effects of these taxes in sequence.

(i) Effect of Proportional Taxation on Distribution. A proportional taxation is one in which the rates of taxation remain constant as the base, i.e., remains the same and the amount of tax payable is calculated by multiplying the tax base with the tax. In short, in proportional taxation tax rate remains the same with the changes in income. But, however, if the income changes in unequal proportions, the inequalities in income will also change.

(ii) Effects of Progressive Taxation. Progressive taxation is one in which the rate of taxation increases as the income base increases. The amount of tax payable is calculated by multiplying the tax base with the tax rate. Under the progressive taxation, the inequalities of income will be reducing, because the higher is the tax rate the more shall be the amount of tax. In other words, the rich would have to contribute more by way of taxes than the poor.

(iii) Effects of Regressive Taxation. Regressive taxation is one in which the rate of taxation decreases as the tax base increases. The amount of tax payable is

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calculated by multiplying the tax base with the tax rate. Under regressive taxation, the inequalities may increase in the distribution of income and wealth, because the burden of taxation will fall more heavily on the poor than on the rich. In other words, the poor would have to contribute more by way of taxes than the rich.

2-Kinds of taxes. Whether the effects of taxation are progressive, regressive or proportional in nature, depends on the kind of taxes, i.e., whether the tax is direct or indirect. We have to discuss the effects of both types of taxes on distribution.

1- Direct taxes and distribution: - Primarily, taxation attempts to reduce the volume of income with the higher income groups and transfer the same to the public (government) authorities who may use the revenue specifically to raise the standards of living of the poor, falls heavily on the rich than on the poor. In general, therefore, all those taxes which fall heavily or exclusively upon the highest income group can have favorable distributional effects also. In this context, the direct taxes which are based on progression and which make use of the various criteria of taxability have the most favorable effects. By direct tax we mean income tax, wealth tax, inheritance tax property tax and gift tax, which are imposed directly on the taxpayer.

2- Indirect taxes and distribution: - Though, in general commodity taxes—excise and sales taxes—are regressive and fall equally on the rich and the poor, yet it is possible to select those commodities, which are normally used by the rich people for special taxation. Luxury excise duties are based on this principle. The superior brand of a commodity may be taxed, while the inferior brands may be exempted. Similarly, different rates of sales taxes may be imposed a higher rate for deluxe goods and lower rate for standard varieties. But in practice, there is the difficulty of choosing goods which are consumed only or mainly by the rich. Besides, introduction of different rates of sales tax will result in complications in collection. Thus, commodity taxes do not generally have favorable distributional effects. It will, therefore, be clear that a country trying to establish an egalitarian society should have more direct taxes rather than depend on indirect taxes.

3- Distribution effects and developing economies: - In any country, the scope for redistribute taxation will depend upon the magnitude of inequalities of income and
wealth. The object of redistribute taxation is to reduce the inequalities of wealth and income, which is the general characteristic of a free enterprise economy. In a developed economy, the volume of production and the size of national income are sufficiently high because of full employment and the high level of factor utilization. It is but natural that economists in these countries do not emphasis the production aspect of the economy but are concerned about the redistribution of national income so that the total economic welfare of the people may be maximized. However, in a developing country, the problem is essentially different. There is both the problem of increasing national income as well as the problem of a better distribution of income. While production is at a low level, as compared to advance nations, distributional of income and wealth is also unjust. While the vast masses of people wallow in poverty and misery, the fortunate few, viz., the landlords, the money-lenders and the entrepreneurs who constitute an extremely small minority enjoy a lion’s share of the national income. It is in this context that the production vs. distribution aspect of taxation in a developing country has to be discussed. In the first instance, not all taxes affect the willingness to work and save. Commodity taxes do not affects upon the willingness to work and save. Direct taxes, especially income and inheritance elsewhere how people will continue to work and even increase their volume of work when their demand for income is inelastic. Further, the incentive to save and accumulate is not affected by death taxes or by capital taxes because the motives for accumulation, as Pigou has so ably demonstrated, are so many and so divers that neither death duties nor property taxes can reduce them.

Secondly, in the context of a planned programme of development of an underdeveloped economy, there is a great need for restriction of consumption and the need to build up savings and investment. The fiscal authorities will have to mobilize the savings of the community and use them to expand the productive capacity of the country. This will necessitate the use of taxation to achieve many simultaneous ends: restriction of consumption of the ordinary masses of people, curtailment of the wasteful consumption of the higher income groups (luxurious houses, dazzling household equipment, useless jeweler, etc.,) diversion of funds to productive investment and the expansion of the public sector. It may be shown
that taxation in a planned economy will fall on all sections of the economy, even the poorest that cannot really afford to pay, but the basic objective is expansion of productive capacity of the nation.  

**III Other Effects of Taxation**

Besides the effects of taxation on production and distribution, it is also important to understand the effects of taxation on the following:

1. **Effects of taxation on employment:** Taxation can be used as a part of policy for studying the demand for labour and thus for reducing unemployment. According to Mrs. Hicks, a rise in the rates of income and capital taxes will tend to check savings and reduce public investment. This will reduce employment opportunities. On the country, a decrease in the rates of income and capital taxes will tend to increase savings and increase public investment. This will increase employment opportunities in a country.

2. **Taxation and inflation:** The main of taxation in times of inflation should be to reduce the purchasing power in the hands of the people. This will result in greatly reducing consumption expenditure and hence reduction in the demand for consumer goods. This helps in reducing inflationary pressure on the economy. Again, heavy taxation or increase in the rates of existing taxes, in times of inflation, transfers purchasing power from the hands of the people to the government which, if used for productive purposes, will increase the level of economic activity and employment and services required. To increase the rate of saving and investment and thus, to increase production, certain tax exemptions and concessions may also be essential in times of inflation.

3. **Taxation and Depression:** The object of taxation in depression period should be to increase the purchasing power of the people, and this objective can be achieved by reducing the burden of taxation on the people, and by transferring the purchasing power from the hands of the richer section of the community to the poor people. The total effective demand increases with the increase in the

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purchasing power of the people, which in turn leads to increase in the level of business activity and employment.

4- Taxation and booms: During the period of booms or rising prices, traders, producers and manufactures are generally benefited for earning huge profits in future. Hence heavy taxation may not have adverse effects.

5- Taxation and consumption: Usually income tax reduces consumption. If income tax is highly progressive, it will have adverse effects.

6-Globalization. Globalization has increased the importance of external actors in shaping national tax policy. Bilateral economic relations between countries, via trade and capital flows often give rise to the need for coordination of tax systems. Bilateral tax relations range from the important institution of bilateral multilateral tax treaties to less formal avenues such as through cooperation between tax administrations, judicial recognition of each other’s legal precedents or adoption of common nomenclature and accounting rules. A second avenue of coordination is via Regional tax administration organization of countries, the most important being the European Union (EU).

6- Taxation and Investment: Taxation is used to encourage investment in local industries among others. Consequently priority sectors of the economy such as agriculture, solid minerals, oil and gas, export and manufacturing are given incentives in order to influence purchasing power and production costs both of which are crucial for the growth industries. With the government recognition of the need to attract foreign investors into the country, diversifying and expanding the export of country as a means of accelerating its economic development as well as the need to encourage existing and intending industries to operate in the country, various tax incentives have been put in place by the government. This study examines the various tax incentive packages that have been made available by the government to corporate bodies in country and goes further to take a critical look at the efficacy of these incentive packages as a means of accelerating the country’s economic development. The immediate problems facing the underdeveloped countries of the world today is to accelerate the tempo of economic growth, which would ensure better standards of living for the masses and bring about some sort of political stability in which further smooth growth of
the economy is made possible. This involves channeling of an increasing volume of resources into investment for productive capital formation both in the public and private sectors. The problem of capital formation in underdeveloped economies breaks down into three main parts.\footnote{United Nations, Tax and Fiscal Policy in Underdeveloped Countries, U.N. Technical Assistance Administration, New York, 1954, p. 3.}

The first concerns the financing of social overhead investment, which must be undertaken directly by the government.

The second deals with an intermediate zone in which the actual investment projects are in private hands but the funds are made available through the government finance.

The third deals with the necessary incentive to private investment, both domestic and foreign, as they are influenced by taxation and other fiscal measure. \"In all three categories, government efforts is directed toward maximizing saving, mobilizing them for productive investment and canalizing them so as to serve the purposes of a balanced development programme.\"\footnote{United Nations, Tax and Fiscal Policy in Underdeveloped Countries, U.N. Technical Assistance Administration, New York, 1954, p. 5.}

Although foreign capital may, to some extent, supplement the domestic capital in such countries, they cannot rely on foreign capital for the immediate task of economic development in order to fulfill the aspiration of the people \"to promote social progress and better standards of life in larger freedom.\"\footnote{Ranger Nurkse, Problem of Capital Formation in Underdeveloped Countries, Oxford University Press, New York, 1921, p. 5.} The underdeveloped countries have, therefore, to put much reliance on domestic sources of finance for capital formation. But it has been pointed out by Ranger Nurkse that a vicious circle exists on both demand and supply sides of the problem of capital formation in underdeveloped countries.\footnote{Ranger Nurkse, Problem of Capital Formation in Underdeveloped Countries, Oxford University Press, New York, 1921, p. 5.} A planned policy of balanced economic development alone can break this vicious circle and initiate a process of cumulative expansion. This involves an accelerated rate of capital formation in these countries, Taxes being an important sources of domestic finance, can go a lone way to augment the resources for capital formation in such countries. In order to achieve a high rate of capital formation in underdeveloped
countries, emphasis must, therefore, be placed on both the demand and supply sides of the problem of capital formation. This implies that the tax structures of developing economies should be so designed that they are not only instrumental in mobilizing savings but also do not adversely affect, the inducement to invest. Moreover, tax policy, besides aiming at economic growth, should play a pivotal role in bringing about economic stability; allocate efficiency, and optimum income distribution in underdevelopment countries.

7. **Taxes and capital formation**: Income taxes may affect capital formation in two ways: by altering the quantity of savings at full employment and thus the maximum possible rate of capital formation (the supply function) and by affecting the willingness to undertake investment and thus the actual level of real capital formation (the demand functions). The real rate of capital formation cannot exceed the level of savings at full employment. Thus the impact of taxes on savings will ultimately determine the impact of taxes upon the level of capital formation. Both theoretical considerations and empirical evidence suggest that for a given individual, savings are positively related to income and possibly to the return to savings. A head tax or poll tax reduces all people's incomes by the same amount but is not related to the return from savings. Thus a poll tax has only an income effect, which will tend to reduce the level of savings both for each household and for the economy as a whole.

**Risk-Taking**

In addition to being related to the after-tax rate of return, the demand for invisible funds and supply of money capital may be related to individual's willingness to take risk. If an income tax affects risk-taking, the previously discussed shifts in the savings and investment schedules may be altered somewhat. Reducing in willingness to take risk will necessitate a somewhat higher rate of return for full employment to be attained; it will alter somewhat the character of investment and it will make the government's task of maintaining full employment more difficult.  

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2.12 - Conclusion

In the foregoing sections we presented the information regarding the theoretical framework of Taxation System, where we studied all components of tax. We discussed the meaning and definition of taxation; also we have known the history of taxation in the world. We have also known Adam Smith's Canon of taxation and other canons of taxation; we have described principles of taxation, purpose of the levy income taxes was also discussed and the impact of income tax in the economic development. Each of these components of income tax system has been discussed in detail for the purposes of understanding the taxation system.