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OVERVIEW OF TAXATION

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ABSTRACT

A tax (from the Latin taxo) is a mandatory financial charge or some other type of levy imposed upon a taxpayer (an individual or other legal entity) by a governmental organization in order to fund various public expenditures.[1] A failure to pay, along with evasion of or resistance to taxation, is punishable by law. Taxes consist of direct or indirect taxes and may be paid in money or as its labour equivalent.

KEYWORDS: ***Authorities, Revisions, Violations, Assesment, Prosecution***

PRINCIPLES OF TAXATION

The 18th-century economist and philosopher Adam Smith attempted to systematize the rules that should govern a rational system of taxation. In *The Wealth of Nations* (Book V, chapter 2) he set down four general canons:

Adam Smith, paste medallion by James Tassie, 1787; in the Scottish National Portrait Gallery, Edinburgh. *Courtesy of the Scottish National Portrait Gallery, Edinburgh*

I. The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.…

II. The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person.…

III. Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it.…

IV. Every tax ought to be so contrived as both to take out and keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state.…

Although they need to be reinterpreted from time to time, these principles retain remarkable relevance. From the first can be derived some leading views about what is fair in the distribution of tax burdens among taxpayers. These are: (1) the belief that taxes should be based on the individual's ability to pay, known as the ability-to-pay principle, and (2) the benefit principle, the idea that there should be some equivalence between what the individual pays and the benefits he subsequently receives from governmental activities. The fourth of Smith's canons can be interpreted to underlie the emphasis many economists place on a tax system that does not interfere with market decision making, as well as the more obvious need to avoid complexity and corruption.

DISTRIBUTION OF TAX BURDENS

Various principles, political pressures, and goals can direct a government's tax policy. What follows is a discussion of some of the leading principles that can shape decisions about taxation.

HORIZONTAL EQUITY

The principle of horizontal equity assumes that persons in the same or similar positions (so far as tax purposes are concerned) will be subject to the same tax liability. In practice this equality principle is often disregarded, both intentionally and unintentionally. Intentional violations are usually motivated more by politics than by sound economic policy(e.g., the tax advantages granted to farmers, home owners, or members of the middle class in general; the exclusion of interest on government securities). Debate over tax reform has often centred on whether deviations from "equal treatment of equals" are justified.

THE ABILITY-TO-PAY PRINCIPLE

The ability-to-pay principle requires that the total tax burden will be distributed among individuals according to their capacity to bear it, taking into account all of the relevant personal characteristics. The most suitable taxes from this standpoint are personal levies (income, net worth, consumption, and inheritance taxes). Historically there was common agreement that income is the best indicator of ability to pay. There have, however, been important dissenters from this view, including the 17th-century English philosophers John Locke and Thomas Hobbes and a number of present-day tax specialists. The early dissenters believed that equity should be measured by what is spent (i.e., consumption) rather than by what is earned (i.e., income); modern advocates of consumption-based taxation emphasize the neutrality of consumption-based taxes toward saving (income taxes discriminate against saving), the simplicity of consumption-based taxes, and the superiority of consumption as a measure of an individual's ability to pay over a lifetime. Some theorists believe that wealth provides a good measure of ability to pay because assets imply some degree of satisfaction (power) and tax capacity, even if (as in the case of an art collection) they generate no tangible income.

The ability-to-pay principle also is commonly interpreted as requiring that direct personal taxes have a progressive rate structure, although there is no way of demonstrating that any particular degree of progressivity is the right one. Because a considerable part of the population does not pay certain direct taxes—such as income or inheritance taxes—some tax theorists believe that a satisfactory redistribution can only be achieved when such taxes are supplemented by direct income transfers or negative income taxes (or refundable credits). Others argue that income transfers and negative income taxcreate negative incentives; instead, they favour public expenditures (for example, on health or education) targeted toward low-income families as a better means of reaching distributional objectives.

Indirect taxes such as VAT, excise, sales, or turnover taxes can be adapted to the ability-to-pay criterion, but only to a limited extent—for example, by exempting necessities such as food or by differentiating tax rates according to "urgency of need." Such policies are generally not very effective; moreover, they distort consumer purchasing patterns, and their complexity often makes them difficult to institute.

Throughout much of the 20th century, prevailing opinion held that the distribution of the tax burden among individuals should reduce the income disparities that naturally result from the market economy; this view was the complete contrary of the 19th-century liberal view that the distribution of income ought to be left alone. By the end of the 20th century, however, many governments recognized that attempts to use tax policy to reduce inequity can create costly distortions, prompting a partial return to the view that taxes should not be used for redistributive purposes.

IMPACT AND INCIDENCE OF TAXATION

Definition of Incidence of Tax:

One of the very important subject of taxation is the problem of ***incidence of a tax.*** By incidence of taxation is meant final money burden of a tax or final resting place of a tax. It is the desire of every government that it should secure justice in taxation, but if it does not know as to who ultimately bears money burden of a tax or out of whose packet money is received, it cannot achieve equality in taxation. If government knows who pays tax, it can evolve an equitable tax system. It can easily tap important sources of taxation and thus can collect large amount of money without adversely affecting economic and social life of the citizens of the country.

Definition of Impact of Tax:

Impact of a tax is on person from whom government collects money in first instance. While incidence of a tax is on person who finally bears burden of a tax.

Explanation:

To make it more clear, we take an **example.** Suppose government levies a tax on electric goods in USA. Tax will be paid to Government in first instance by manufacturers of electric goods. Impact of tax is, therefore, on them. If manufacturers of electric goods industries add tax to price and succeed in selling goods at higher prices of electric goods to consumers, burden of tax is thus shifted on to consumers.

Incidence is Different From Shifting:

Incidence is final resting place of a tax while ***shifting*** is process of transferring money burden of tax to someone else. Shifting finally ends in incidence. When a person on whom tax is levied tries to shift tax on to the other, he may succeed in shifting tax completely, partly, or may not succeed at all. Shifting of tax can take place in two directions, forward and backward. If tax is shifted, from seller to consumer, it is a case of **forwarding shifting.**

Backward shifting takes place when consumers do not purchase commodities at increased prices. Sellers are! then forced to cut down prices and bear burden of tax themselves. Backward shifting is thus performed by buyers.

Incidence and Effect of a Tax:

Before we proceed further it seems necessary that we should distinguish the concept of incidence from effect. As stated earlier incidence is direct money burden of a tax. Effect of taxation is repercussions or consequences! of imposition of a tax on individuals and on community in general.

CANONS OF TAXATION

The canons of taxation were first presented by Adam Smith in his famous book 'The Wealth of Nations'. These canons of taxation define numerous rules and principles upon which a good taxation system should be built. Although these canons of taxation were presented a very long time ago, they are still used as the foundation of discussion on the principles of taxation.

Adam Smith originally presented only **4 canons of taxation**, which are also commonly referred to as the 'Main Canons of Taxation' or 'Adam Smith's Canons of Taxation'. Along with the passage of time, more canons were developed to better suit the modern economies. In the following article, you will read the **9 canons of taxation** that are most commonly discussed and used.

Adam Smith's Canons of Taxation:

Adam Smith originally presented the following four canons of taxation. The rest were developed later:

1. Canon of Equality
2. Canon of Certainty
3. Canon of Convenience
4. Canon of Economy

These **9 canons of taxation** are:

1. *Canon of Equality*
2. *Canon of Certainty*
3. *Canon of Convenience*
4. *Canon of Economy*
5. *Canon of Productivity*
6. *Canon of Simplicity*
7. *Canon of Diversity*
8. *Canon of Elasticity*
9. *Canon of Flexibility*

1. Canon of Equality:

The word equality here does not mean that everyone should pay the exact, equal amount of tax. What equality really means here is that the rich people should pay more taxes and the poor pay less. This is because the amount of tax should be in proportion to the abilities of the taxpayer. It is one of the fundamental concepts to bring social equality in the country.

The canon of equality states that there should be justice, in the form of equality, when it comes to paying taxes. Not only does it bring social justice, it is also one of the primary means for reaching the equal distribution of wealth in an economy.

2. Canon of Certainty:

The tax payers should be well-aware of the purpose, amount and manner of the tax payment. Everything should be made clear, simple and absolutely certain for the benefit of the taxpayer. The canon of certainty is considered a very important guidance rule when it comes to formulating the tax laws and procedures in a country. The canon of certainty ensures that the taxpayer should have full knowledge about his tax payment, which includes the amount to be paid, the mode it should be paid in and the due-date. It is believed that if the canon of certainty is not present, it leads to tax evasion.

3. Canon of Convenience:

Canon of convenience can be understood as an extension of canon of certainty. Where canon of certainty states that the taxpayer should be well-aware of the amount, manner and mode of paying taxes, the canon of convenience states that all this should easy, convenient and taxpayer-friendly. The time and manner of payment must be convenient for the tax payer so that he is able to pay his taxes in due time. If the time and manner of the payment is not convenient, then it may lead to tax evasion and corruption.

4. Canon of Economy:

The whole purpose of collecting taxes is to generate revenue for the company. This revenue, in turn, is spent on public welfare projects. The canon of economy – keeping in view the above-mentioned purpose – states that the cost of collecting taxes should be as minimum as possible. There should not be any leakage in the way. In this way, a large amount of the collections will go directly to the treasury, and therefore, will be spent in the government projects for the welfare of the economy, country and the people. On the other hand, if the canon of economy isn't applied and the overall cost of collecting taxes is unreasonably high, the collected amount will not be sufficient in the end.

5. Canon of Productivity:

By virtue of the canon of productivity, it is better to have fewer taxes with large revenues, rather than more taxes with lesser amounts of revenue. It is always considered better to impose the only taxes that are able to produce larger returns. More taxes tend to create panic, chaos and confusion among the taxpayers and it is also against the canon of certainty and convenience to some extent.

6. Canon of Elasticity:

An ideal system of taxation should consist of those types of taxes that can easily be adjusted. Taxes, which can be increased or decreased, according to the demand of the revenue, are considered ideal for the system. An example of such a tax can be the income tax, which is considered very much ideal in accordance with the canon of elasticity. This example can also be taken in accordance with the canon of equality. Flexible taxes are more suited for bringing social equality and achieving equal distribution of wealth. Since they are elastic and easily adjustable, many government objectives can be achieved through them.

7. Canon of Simplicity:

The system of taxation should be made as simple as possible. The entire process should be simple, non-technical and straightforward. Along with the canon of certainty, where the amount, time duration and manner of payment is made certain, the canon of simplicity avoids cases of corruption and tax evasion if the entire method is made simple and easy.

8. Canon of Diversity:

Canon of diversity refers to diversifying the tax sources in order to be more prudent and flexible. Being heavily dependent on a single tax source can be detrimental for the economy. Canon of diversity states that it is better to collect taxes from multiple sources rather than concentrating on a single tax source. Otherwise, the economy is more likely to be confined, and hence, its growth will be limited as well.

9. Canon of Flexibility:

Canon of flexibility means that the entire tax system should be flexible enough that the taxes can easily be increased or lowered, in accordance with the government needs. This flexibility ensures that whenever the government requires additional revenue, it can be generated without much hassle. Similarly, when the economy isn't booming, lowering taxes shouldn't be a problem either.

CONCLUSION

So these are the 9 canons of taxation that are used as the fundamentals for any taxation system and study about taxation principles. As mentioned earlier, Adam Smith originally presented the first four canons. Later, in order to better suit to modern economies and for the sake of evolution as well, more canons were introduced. I hope the explanation was easy to comprehend.