CHAPTER I

THEORETICAL REVIEW OF THEORY OF DIRECT TAXES

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1.1 INTRODUCTION :

In planned economic development of India the Govt. is expected to mobilise its own resources. The resources mix available is of varied nature consisting of different sources like surpluse generated from public sector borrowing,capital market & taxation. However, in recent times the Govt. is increasingly reling on the source of taxation to meet the growing need of development finance.

The present structure of taxation in India is hardly based on indirect taxes. However, long term fiscal policy of Govt. of India has expected a gradually increasing share of direct taxes in tax structure to meet the growing need of development finance.

It is in this context, that the present study will attempt to evaluate the contribution of direct taxes only in terms of resource mobilisation.

1:2 OBJECTIVES :

The researcher has kept the following objectives for the purpose of this study.

a) To evaluate the contribution of direct taxes in resource mobilisation for five year plansof India.

b) To examine the source of direct taxes vis-a-vis indirect taxes in planned economic development.

1:3 **METHODOLOGY :**

The present study is an attempt of examining the contribution of direct taxes to planned development in India. Naturally the entier work require careful scrutiny of tax receipts from both the sources i.e. direct taxes & indirect taxes.This data is mainly the secondary data which is already compiled by the Reserve Bank of India.

This study is based on mainly secondary data, & researcher have been concentrated the following sources for collecting this data.

a) Annual Report on currency & finance of Reserve Bank of India. 83-84 to 88-89.

b) Statistical outline of India (88-89) published by Tata Surveses Pvt.Ltd.

c) HNPS Suman, Direct Taxation & Economic Growth in India, 1974, Sterling Publishers Pvt. Ltd.

d) R. N. & M. Tripathi, Public Finance & Economic Development in India, 1985, Mittal Pub. Pvt. Ltd.

1.4 PRINCIPLES OF TAXATION :

Taxes have a deep and wide economic implications. A tax system should, therefore, be designed carefully. In order to make it ideal, a tax system of any country should adhere to certain basic principles.

These principles were first enunciated by Adam Smith in the form of canon of taxation. He has prescribed four canons which must be followed if the various objectives of taxation are to be realised. These are as follows :-

1. CANON OF EQUITY :

As per the above principle, the burden of taxation should be distributed in such a way as every citizen's share is equal to the others. According to Adam Smith, "the subject 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 protection of the State."[1] Rich people must be subjected to higher taxation as compared to poor people. Progressive system of taxation satisfies this principle.

2. **CANON OF CERTAINTY** :

A tax which each individual is bound to pay, ought to be certain and not abritrary. The time of payment, the manner of payment, the quality to be paid ought to be clear and plain to the contributor and every other person. The idea behind this canon is that there should not be any confusion in the mind of tax payer about the amount of tax. In absence of certainty the tax payer may be unnecessarily harassed and corrupt practices follow.

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1. Mankar, Kulkarni et.al, Public Finance & Policy, Himalaya Publishing House, Bombay, 1978, P. 32.

3. **CANON OF CONVENIENCE :**

This canon of taxation demands that the tax system should be devised for the convenience of the tax payers. The time of payment as well as the mode of payment should be so fixed as to create the minimum inconvenience for them. The income tax deducted at sources satisfies this principle.

4. **CANON OF ECONOMY :**

This canon warns the tax authorities to administer the system in such a manner as to ensure that the cost of collecting the tax revenue is very low. It remarks Adam Smith, "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 it brings into the public treasury of the State."[2] These canons of taxation are considered to be the 'Fundamental' and are of great practical significance.

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1. Ibid, P. 34.

1.5 EQUITY CONCEPT IN TAXATION :

The concept of equity in taxation refers to the social justice in allocation of tax burden. Taxation imposes burden upon tax-payers. There is money burden and real burden of taxation which may be direct and indirect. Thus it becomes essential that the burden of the taxes divided 'fairly'. Government is responsible to provide certain facilites to the citizen. It has to adopt a definite principle and definite machinery to apply these principles.

As such, to determine the possible base of allocation of tax burden in an equitable manner, various principles of taxation enunciated by economist. The most prominent principles of taxation are :-

a) The benefit theory,
b) The cost of service theory, &
c) Ability to pay theory.

a) THE BENEFIT APPROACH :

This theory contents that in order to secure justice in taxation the tax should be proportional to benefit enjoyed by each individual under the projection of the state. Thus whoever enjoy a great benefit from financial activities of government should correspondingly pay more to meet such public expenses. Hence, "taxes were to be regarded as a natural price to be paid for protection or membership in the association of organised society of the state."[1] Adam Smith also advocated the benefit principle in enunciating first maxim of taxation that, the subject of every state ought to contribute towards the support of the government as nearly as possible in proportion to their respective ability, i.e. in proportion to the revenue which they respectively enjoyed under the protection of the state.

It seems that Smith poses both ability and benefit approaches. Thus according to this principle the aggregate benefit provided by the government should at least be compensable to the collective sacrifice made by the individual in form of taxes.

b) COST OF SERVICE OR COST SERVICE THEORY :

Cost of service theory explains that cost

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1. Musgrave R. A., The Theory of Public Finance, McGraw Hill, New York, 1959, P. 64.

incurred by the government in providing certain services to the people must be collectively met by people who are ultimate receivers of the services.

This principle suggests that the burden of taxes should be allocated among the different people on the basis of cost of benefit provided to them. This theory treats tax as a price which should be charged with the person using the particular services.

c) **THE ABILITY TO PAY APPROACH :**

In modern taxation, the ideal of justice or equity is endorsed by the principle of ability to pay. This principle suggests that every person should be taxed according to his ability to pay. It implies that the broadest shoulders should bear a heaviest burden. That the person having a greater ability to pay should be taxed heavier while those with less ability should be taxed lesser and those lacking ability be exempted.

The ability approach is based on assumption that those who possess income or wealth, therefore, placed in better economic circumstances, should contribute to finance the public activities according to relating abilities. The principle of ability, however, involves the problem of measuring ability. There are two distinct approaches :-

1. Subjective, and
2. Objective.

On the ground of subjective~~s~~, criterion the ability to pay is measured by disutility or sacrifice involved in tax payment. Subjective test is based on psychological reaction of tax payers as to what burden is borne by him on account of tax.

In objective approach, the faculty theory has been enunciated by some American thinkers. The term faculty used here indicates ability in objective or concrete sense. The theory, unlike the sacrifice theory consider the "Money value of taxable capacity" of the tax payer and not his feelings. The faculty theory considers not only tax payers' income as such, but also as how this income has been earned.

Thus the problem as to how to achieve justice or equity in taxation and judging the burden of taxation, the tax system as a whole should be evaluated rather than a tax inisolation. It is quite possible that inequity of one tax may be corrected by equity of another. Thus while imposing the new tax, authority must assess its impact on the existing tax structure and total burden as a whole, also judged.

1:6 CONCEPT OF INCIDENCE IMPACT & SHIFTING :

Whenever the tax is levied and collected by the government, some burdens are created, which may be classified into monetory and real burden of taxation. Monetory burdens may be further divided into immediate money burden and ultimate money burden. This classification leads to the concept of impact, shifting and incidence.

IMPACT OF TAXATION :

By impact, it mean immediate burden of tax. The impact of tax, is on person, who has bears its immediate money burden who has to pay amount of tax in the first instance and who is legally and immediately responsible for payment to Government.

SHIFTING OF TAXATION :

The process of passing on or transfer in the direct money burden of tax from the point of impact to the final resting place is called a shifting of tax. This will be done through the price adjustment from the point of impact to the final resting place is called shifting.

INCIDENCE OF TAXATION :

The term incidence of taxation is defined by some economicsts as the direct money burden of a tax. In words of Dalton, who has given most workable definition of incidence, "the incidence of tax is upon those who bears the direct money burden of the tax".[1] Thus the final resting place of them money burden of the tax is called incidence of the tax.

The person who initially pay the tax to Government bears the impact of the tax. In other words who pays tax in first instance bears the impact of that tax. But he may or may not bear the ultimate burden of tax. If he bears, the impact and incidence on same person. If not, the incidence of tax on other person. Who cannot shift the burden of tax to any person. Thus incidence is,therefore, refer to the direct money burden only. All other burdens called the effects of taxes resulting from incidence. Seligman uses the term incidence to denote the settlement of burden on ultimate tax payer.

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1. Hugh Dalton : Principals of public finance Routledge & Kegan Paw Ltd. London - 1964, P - 36.

According to him, firstly a tax may be imposed on some person, secondly it may be ultimately borne by this second person or it may be transfered to others of by whom it finally assumed. The process of transfer of the tax is known as shifting, while settlement of the burden on the ultimate tax payer is called the incidence of the tax .[1]

MUSGRAVER'S CONCEPT OF INCIDENCE :

Musgrave has introduced concept of specific tax incidence and differential tax incidence. He argued that whenever tax is imposed or the rate of a tax are changed, the pattern of distribution of income available for the private sector is changed. This change in distribution pattern of income is known as specific tax incidence.

Sometime the Government substitutes one tax by another. When this is done, a change in the distribution pattern of income taxes place. This change is referred to as differential tax incidence.

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1. E.R.A.Seligman : The shifting & incidence of taxation (1921), Macmillan Company,Chapter II.

FACTORS OR PRINCIPALS DETERMING SHIFTING AND INCIDENCE OF TAXES :

a) Elasticity of demand and elasticity of supply - If we concerned with commodiaties the incidence will depend upon elasticity of demand and supply of commodity. If demand is perfectly elastic the entire tax burden is upon seller or if price is raised due to the tax, the demand will be zero. But when demand is inelastic, the entire tax burden will be passed on buyers for the demand remain constant. Whatever price rise due to the tax. If the supply perfectly elastic entire tax burden is shifted to buyers and if it is inelastic the burden will on the seller. When the elasticity of the supply is equal to the elasticity of demand tax burden will be equally divided between buyer and seller. The supply is more elastic, a great part of the tax burden will be upon the buyer and vis-a-vis.

Some other factors as determining shifting and incidence of taxes will be as follows :-

b) Period of time,

c) Behaviour of cost

d) Nature of tax

e) Market conditions

f) Price adjustment

1:7 DISTINCTION BETWEEN DIRECT & INDIRECT TAXES :

A necessary first step in tax analysis is classification. Before we can begin the task of tracing the operation of particular taxes, through the economic system. It is necessary to divide them into convenient groups. "The direct and indirect distinction has been far the most commonly used classification especially in Britain for the reason that it was one which has legal and administrative backing".[1]

Undoubtedly India mostly under the British rule and hence the same classification frequently used in India. The essence of the British distinction between direct and indirect taxes lies in the relation between tax payer and revenue authority. Though the distinction based in Britian, most of nations usually not classed quite in this way.

The distinction between direct and indirect taxes is not always satisfactory hence most schollars while -

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1. U.K. Hicks : Public Finance, Oxford University Press, 1968, P - 133.

differentiating the qualities of direct taxes from indirect one could not be able to give clear meaning of direct and indirect taxes. Therefore, the wide contraversy also exists as to the definition and natue of direct and indirect taxes. As Prof. Dalton put its "The idea often underlying this distinction is that a direct tax really paid by person on whom it is legally imposed while an indirect taxes is conceived as one which can be shifted or passed on; a direct tax one which cannot".[1]

As observed by Due, " little is to be gained by seeking to establish the definition of direct and indirect taxes, however direct tax can be interpreted as referring to personal and corporate income as well as death taxes, where indirect tax as referring to levies upon production and sale of commodity".[2]

The distinction often useful with view to devising a tax system which distributes the burden of the tax equitably. As taxation has an important impact on the nations economy, tax system should design to achieve the desired objectives mearly serving as a

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1. Hugh & Dalton : Op.Cit., P - 33.
2. Vinay Kumar : Tax system in India & Role of Income Tax, Deep & Deep Pub-New Delhi,1988 P - 19.

source of revenue. In general it should ensure fairness, promote savings and investment and be capable of efficient administration. Therefore ideal tax structure of direct and indirect is necessary. "Keeping balance between direct and indirect taxes an idea encouraged by Gladstones, well known simile, in which he likened these two sources of revenue to 'to attractive sisters' as between whom he was'perfectly impartial,' believing that as chancellor of the Exchequer, it was not only allowable, but even of act of duty, to pay my address to both of them"[1] considered to be sign of financial vertue.

To achieve socio-economic objectives and level of development, an ideal tax system will be designed in the light of national policy. An ideal tax system shall also a judicious combination of both direct and indirect taxes.

There has been a long tradition in economics literature to classified taxes into these two categories, one way of distinguishing these two has been in terms of the incidence of taxation. J.S.Mill and other

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1. Hugh Delton : Op.Cit., P - 24.

distinguishing on this basis. According to them," if incidence of tax rest upon the person who bears its impact also, then it is direct tax and on the other hand, if incidence is passed on to other, then it is an indirect tax".[1] However such distinction is not easy to maintain especially because in some cases the incidence of tax may be shift partly and in some cases fully or even more than fully. Because of these complications, Taylor discard this distinction and he say "the term direct and indirect tax are finally distinguishable in meaning only interms of shiftability. Direct taxes are not shifted while indirect taxes shifted easily".[2]

In economics literature we also come across many other basis of direct and indirect tax distinction i.e. taxes on production are direct, those on consumption are indirect. Similarly on the other hand, taxes on income are direct and those on expenditure is indirect. But even these types of distinctions do not have sound economic basis.

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1. J.S.Mill : Principals of Political Economy, Ashley (ed) 1909, P - 823.
2. Philip E. Taylor : the Economics of Public Finance, The Macmillon Company, New-York 3rd (Ed), 1968, P - 307.

Thus the economists have not able to give the satisfactory distinction between direct and indirect taxes even today. The concept used by different nations and persons accordingly their own points of view.