**Canons of Taxation**

## **Taxable Capacity**

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## **Taxable Capacity**

According to **Sir Josiah Stamp, "**Taxable capacity is that maximum amount which the community is in a position to bear towards the expenses of public authorities without having a miserable and down-pressed existence and without dislocating the economic organization too much".

In the words of **Findlay Shiraz,** "It is the optimum taxability of a nation, the maximum amount of taxation that can be raised and spent on the economic welfare in that community".

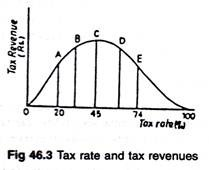
**In his book Principles of Public Finance, Dalton writes** that "Absolute taxable capacity is a myth and should be banished from all serious discussions of public finance".

Indian Taxation Enquiry Commission defines taxable capacity as a relative concept. It is the degree of taxation beyond which productive effort and the efficiency as a whole begin to suffer."

In a nutshell, taxable capacity is the maximum amount that a nation can contribute to the government's support without causing harm to the economy. It is also pertinent to discuss that the amount of tax burden that a country's citizens are prepared to bear is not rigidly fixed. It can increase or decrease with a change in the distribution of income, resources, the size of the population, method of taxation, etc. Thus, it can be surmised that the limit of taxable capacity is relative rather than an absolute quantity.

**The Laffer Curve for Determining Taxable Capacity**

The Laffer curve is getting a lot of attention these days as a hot idea in economics. But it isn't at all new a concept—and is not very complicated. The bullet-shaped curve below shows the relationship between tax rates and government revenues. As tax rates rise from zero, revenues increase until an optimum point (C) is reached. But if taxes are increased further (points D and E), Prof. Laffer says, they discourage consumer spending and business investment, thus reducing revenues. A 100 per cent tax rate would be confiscatory, stopping all production and eliminating all tax revenue.



Prepare new chart

**Absolute and Relative Taxable Capacity**

Dalton opines that taxable capacity is a common phrase, but a dim and confused conception. To explain in more sophisticate way, the taxable capacity can be categorized in two classes:

**(a) Absolute Taxable Capacity:** Absolute taxable ability means the amount of money or the proportion of national income that can be withdrawn from people by the government in the form of taxes without adversely affecting them.

**(b) Relative Taxable Capacity:** It refers to comparing the absolute taxable capacity of different taxpayers or industries, or groups of taxpayers. Relative taxable ability refers to the proportion to which to meet some ordinary expenditure, two or more communities may contribute to taxes. In other words, the relative taxable capacity of the community to contribute, concerning the capacity of other communities, to some common expenditure.

For example, person A will have double the potential to pay compared to person B since A's relative taxable capacity is double B's actual taxable capacity. Similarly, B's relative taxable potential is half of A's taxable ability.

Indeed, calculating absolute taxable potential is very difficult. To test it, there is no clear norm. In a sense, absolute taxable potential can be limited by the entirety of a country's capital. But is it feasible in a democratic country to tax to such an extent? Some economists think that in terms of the amount of tax that can be raised without causing the taxpayers any distress, absolute taxable capacity should be calculated.

**Significance of Taxable Capacity**

The understanding of the taxable capacity of the community is of great use to the government in many ways. The notion of taxable capacity is significant because of the following reasons:

1. The information will be helpful for the mobilization of economic resources for purposes of economic planning.

2. During periods of war, it is vital for the government to know the maximum amount that the people can contribute to the war's prosecution.

3. It will prevent the government from imposing unnecessary taxes, which may prove annoying than productive, resulting in dissatisfaction among people.

4. The concept of taxable capacity is vital in federal finance. It is helpful for comparison between the different contributors in order not only to allocate the burdens of taxation but also to facilitate the solution of the various problems connected with the financial relations between the state and the federal government.

5. Eventually, the concept also helps to formulate a national policy for the wholesome development of the country.

**Canons of Taxation**

It has been proved that much of the revenue is generated by taxation in every country. Taxes are also mandatory payments to governments without the taxpayer's hope of direct return or benefit.

Profile Bastable "defined a tax is a compulsory contribution of a person's wealth for the service of public power".

According to Taussing, "the essence of a tax as distinguished from other charges by government is the absence of a direct 'quid-pro-quo' between the taxpayer and the public authority".

Prof. Adams presented a comprehensive description of a tax that highlights the different aspects of taxation. He says, "a tax is a source of derivative income from the state's point of view.

A tax is a coercive payment from the point of view of the person. From the administrative point of view, it is a demand for money by the state in compliance with defined rules. From the perspective of the theory, a tax is a donation from individuals for common expenditure."

Tax is an obligatory donation from the person to the government to pay expenses incurred in the common interest of all without regard to the particular benefit conferred.

A tax is leakage into the public sector from the circular flow of profits. It is paid for by citizens, companies, and other individual associations. It reflects a payment from people's wages. We literally mean the characteristics that a good tax system should possess. Tax canons are connected to the administrative part of the tax. In 1776, Adam Smith first devised the taxation principles or canons.

#### ****Types of Canons of Taxation:****

**Tax canons of Smith are indeed,' classic' in this context. His four Taxation Canons are:**

(i) Canon of equality or equity

(ii) Canon of certainty

(iii) Canon of economy

(iv) Canon of convenience.

Apart from the above four canons, economists Bastable have added a few more relevant canons as follows:

(v) Canon of productivity

(vi) Canon of elasticity

(vii) Canon of simplicity

(viii) Canon of diversity.

Chart

**i. Canon of Equality:**

The Canon of Equality enunciates that the tax burden must be divided equally or equitably amongst taxpayers. However, since not all taxpayers have the same opportunity to earn and to pay taxes, this kind of equality deprives justice. Wealthy individuals should pay more taxes than poor individuals. Thus, justice demands that an individual with greater capacity to pay high taxes. If anyone is asked to pay taxes according to his or her capacity, then all taxpayers' sacrifices are equal. This is the core of the equality (of sacrifice) canon. Taxes are to be levied in accordance with the concept of willingness to pay to establish the dignity of sacrifice. Considering this, the two sides of the same coin are the canon of equality and the principle of capacity.

**ii. Canon of Certainty:**

The tax that a person must pay should be certain and not subjective. According to A. Smith, the payment time, payment method, and the sum to be paid, i.e., tax liability, should all be transparent to the contributor and everybody. Thus, a lot of things are accepted by the canon of certainty. Both the taxpayer and the tax-levying authority must be confident of that. Taxpayers should not only know about what, where and how much tax is to be paid. The assurance of responsibility, in other words, must be understood beforehand. Similarly, the revenue that the government expects to raise during the given time must also be certain. In these respects, any amount of uncertainty could cause a lot of trouble.

**iii. Canon of Economy:**

This canon means that as little as possible should be the cost of collecting a fee. Any taxation system which involving high administration costs and unusual delays in assessment should be avoided. **According to A. Smith: "Every tax should be constructed to take out and hold as little as possible out of the wallets of the people, over and above what it puts into the State's public treasury."**

**iv. Canon of Convenience:**

Taxes should be assessed and collected in a way that provides not only the taxpayer but also the government with the most incredible comfort. Thus, it should be simple and trouble-free for taxpayers.

**"Every tax system ought to be levied at the time or how it is most likely to be convenient for the provider to pay it."** Take, for instance, the agricultural income tax is collected after the harvest, and salaried individuals are taxed at the source. So, this canon is paramount from the view of a point of taxpayer and government as well.

**v. Canon of Productivity:**

In the word of Charles F. Bastable, taxes must be productive or cost-effective. Productivity means that there must be a significant revenue yield from every levy. In addition, this canon notes that only certain taxes that do not hamper the community's constructive activities should be levied. A tax is said to be a product only when it renders as an incentive to the productivity of individual or corporate.

**vi. Canon of Elasticity:**

Modern economists attach considerable significance to the elasticity canon. This canon suggests that in yield, a tax should be flexible or elastic. It should be charged so that the tax rate can be adjusted according to the demands of the case. Whenever the government needs revenue, by raising tax rates, it must collect as much income as possible without creating any negative consequences. The Indian income tax follows this canon in general.

**vii. Canon of Simplicity:**

Every tax must be understandable and straightforward to the people to calculate it without taking the help of tax experts/consultants. A dynamic and difficult tax is bound to create adverse side effects. When the tax system is found to be complex, it can allow taxpayers to evade taxes.

In addition, a complex tax structure is costly in the sense that tax experts would have to seek advice from even the most truthful, trained taxpayers. Such a tax scheme inevitably can breed corruption in society.

**viii. Canon of Diversity:**

Taxation should be dynamic in nature. This means that a country's tax structure ought to be diverse rather than a single, rigid or two-hand taxation system. If a single tax structure is implemented, only a particular sector would be needed to pay the national exchequer, leaving many citizens unaffected. Such a tax scheme would undoubtedly have the greatest effect on existing taxpayers. The distribution of the tax burden among the large population would result in a complex or diversified tax system, resulting in a low degree of tax incidence in the aggregate.

**In the real world, such an ideal tax structure is seldom observed.** But the tax authority must continue to retain the above taxation canons relentlessly to set up a near-ideal tax structure.

## **Factors Determining of Taxable Capacity**

Although many factors have a profound effect on the taxable capacity of an individual, among these, the most prominent are:

**(i)** **Size of Population:**Taxable capacity is highly influenced by national income rise and population growth rates. Where the rise in national income is higher than that of population growth, per capita income rises. The taxable capacity of individuals is growing. On the flip side, if the rate of growth of the population is higher than the national income, the taxable ability declines.

**(ii)** **Distribution of National Income:**Taxable potential is also influenced by the distribution within a nation of national income. If the distribution of wealth in the country is unequal, the nation's taxable capacity will be high. Still, if the income is distributed equally, then the taxable capacity will be poor. A man is earning a revenue of Rs. 40,000 a month can pay more to the government than 20 persons earning Rs. 30,000 per month.

**(iii)** **Character of Taxation:**If taxes are devised wisely, they give citizens less frustration and generate a large yield for the government.

**(iv)** **Purpose of Taxation:**Taxation purposes directly affect a nation's taxable power. If citizens of the country are happy with taxation, i.e., the increase in people's welfare, they are more likely to pay government taxes. Whereas they refuse to pay taxes if they find the money would be used for unproductive purposes. Therefore, we conclude that if the state invests income for purposes such as education, sanitation, the fight against drought, diseases, etc., then the nation's taxable capacity grows to its fullest (E.g. Japanese economy). If income is expended for unproductive purposes like in developing country like India, such as war, then the taxable capacity shrinks.

**(v)** **Psychological factor:**In deciding a nation's taxable ability, a psychological factor is significant. Suppose people are happy that the government is doing its best to increase the living standard and preserve the country's reputation. In that case, they try to sacrifice what to say about the government's money for their lives.

**(vi) Living Standard:**When people's living standards are good, they function more successfully to achieve an even better quality of living. They earn higher pay from their employers when they work enthusiastically, resulting in taxable capacity continues to grow.

**(vii)** **Effect of inflation:**If the country is in the grip of inflation, people's purchasing power is diminished, the nation's taxable capacity shrinks significantly. But if the value of money is high and the country is not facing unemployment, then people's taxable ability is very high.

We have discussed above the different factors on which a nation's taxable capacity depends. We cannot identify any factor and say that only this factor alone determines taxable capacity. The truth is that multiple variables determine taxable capacity, and we must take them all into account when deciding the maximum amount that a country's people can pay. We cannot deny that calculating taxable potential is a very tedious task, but this does not mean that we do not try because many difficulties are plaguing it.

**Measurement and Limit of Taxable Capacity:**

Several economists endeavored to determine taxable capacity of a person or system. Prof. Colin Clark has made a real attempt to measure it. In his book "Welfare and Taxation" he has argued that the maximum taxable capacity would be 25% of national income for most countries of the world. In the words of Clark, if taxation surpasses 25% of the safe limit, it may generate the following unfavorable consequences:

(i) A taxation more than 25% will negatively affect the willingness to work and save. Thus, subsequently reduce the level of national income.

(ii) A high level of taxation creates an adverse effect on willingness to save and invest and thereby impede capital formation.

(iii) High taxation affects every corner of production. Dishonesty and insensitive attitude develop in both employers and employees in industrial output and other productive areas.

(iv) Workers faced with heavy taxation and a rise in prices would fight for higher wages. This will further fan the flames to inflation in the economy.

(v) It can be said that high rate of taxation will also have an unpleasant political effect. It's worth emphasizing Dalton's judgment on this topic of taxable capacity. It is impossible to determine any exact sum that might be said to represent the country's taxable capacity at any given time.

When consumption is reduced as a result of an excessive tax burden, the limit of taxable capacity is said to have been reached. The manufacture of industrial goods will be severely harmed. Furthermore, the collection will be expensive.

As a result, more taxation may not result in more surplus revenue. Taxable capacity, according to some fiscal theorists, is achieved when taxpayers are forced to sell their stocks to satisfy their tax liabilities.