PRINCIPLE OF TAXATION IN DEVELOPING ECONOMY

In this section, we will discuss whether the principle of taxation is relevant to developing economies. If not what principle should be suggested which would serve the requirements of such countries.

It should be clearly noted that the features of developing countries are different from that of developed countries. Therefore, it might be dangerous to utilize in one area the experience gained in another because such attempts may lead to disaster results. *J.F. Due* has correctly pointed out that the greatest hazard of this nature is the attempt to transfer the tax structure of highly developed nations to one in earlier stages of growth.

Objectives of Taxation in Developing Countries

In the context of planned economic development of developing countries, there are three main objectives of taxation as under :

(*i*) **Growth Objective.** Economic development is measured in terms of increase in per capita real income. In order to attain it, the rate of investment in both public and private sectors should be accelerated. In the absence of foreign assistance, investment has to be financed by domestic savings. Tax policy should be designed as to exercise a favourable impact on all the three constituents of total domestic savings. Then, it should be such that households pay the tax by curtailing their consumption expenditure. Similarly, corporate savings should not be adversly affected. Lastly, it should fetch increasingly larger amount of tax revenue to the Govt. Simultaneous attainment of all these may be in conflict and the tax structure should be designed as to reconcile them as far as possible and this is largely achieved by heavy reliance on indirect taxes.

Growth oriented tax policy cannot neglect its impact in a mixed economy on the private sector. Every effort should be made to develop a tax structure which besides fetching large revenue to the public exchequer provides incentives to private saving and investment. This role of taxation conflicts with the principle of economic neutrality.

(*ii*) **Equity Objective.** Equity in taxation refers to taxation according to ability to pay. Benefit principle may be of use in specific cases only. There are two aspects of equity-horizontal and vertical. The problem of equity cannot be neglected in developing countries. A tax system which caters to the equity objective has to be progressive. It is often said that there is conflict between such redistributive taxes and growth. They are likely to have adverse effect on work effort. There is not much force in these agruments. Moreover, the well do to classes in poor countries are not renowned for their frugality. On the other hand, there may be a good deal of complimentarity between redistribution and growth.

(*iii*) **Stabilization Objective.** Since the process of planning is necessarily inflationary, prevention of inflationary pressures on prices assumes particular importance in developing countries. The Indirect Taxation Enquiry Committee of India, found the contribution of direct and indirect taxes a positive role in controlling inflation. Universal direct taxes curb aggregate demand without affecting consumer sovereignity. Indirect taxes can affect the demand for different products differently. They can curtail the demand for those goods which are in short supply.

As regards the commodity taxation, the economists usually consider it in the context of its resource allocation effect. They choose a particular resource allocation as the most efficient one and consider deviations therefrom as the cost to the economy. One such resouce allocation is that which conforms to the Paretian type. A Paretian optimality would indicate that it is not possible to shift and increase efficiency of resource use along one line without reducing it along some other line. This resource optimality ignores the possibility that the addition in efficiency may exceed the reduction in it through such a shift. Leaving aside Paretian optimality, one solution to the optimal taxation is that of imposing lump sum taxes. It is argued that a lump sum tax does not affect either the marginal cost of production to the producers or marginal utility of purchases to the consumers. However, since every tax has an income effect, the marginal utilities are bound to be altered particularly because the marginal utility schedules of commodities differ from each other. Futher, this reasoning does not enable us to decide the way in which tax liability should be distributed amongst tax-payers. Any decisions will have its distributive and welfare repercussions also and the actual effects on resource allocation via demand for goods and services would depend, amongst other things, on demand elasticities for final consumption goods.

A tax on profits is consistent with Paretian optimality. Such a tax, it is claimed, is neutral with respect to production and investment decisions. But it ignores the possibility of a depressing effect on capital formation. When income earners find that income from profits has fallen, their perference moves in favour of current consumption at the cost of savings and investment which in turn slows down the rate of economic growth. During the course of discussing tax optimality we should keep in view the growth efficiency with operational efficiency of the economy. This question is also debatable whether the authorities can raise all the needed tax revenue from 'neutral' taxes alone. Any tax which tries to touch all or a large number of incomes will have to be based upon a large number of considerations like income elasticities of goods and services. The problem defies a satisfactory and practical solution especially in the dynamic set up. The problem becomes still more acute when we introduce the possibility of various direct taxes other than the one on income.

Considering the indirect taxation, Paretian optimality cannot be taken as the ideal one, at least on two grounds. Paretian optimality ignores the wide-spread existence of extrernalities and the possibilities of accelerating the pace of economic growth through a shift in the rate of saving and in investment pattern.

Therefore, uniform taxation of all goods at equal percentage rates would amount to raising the same tax revenue on a lump sum basis since all tax-payers, find a proportionate reduction in their incomes. Accordingly this tax should have no resource allocation effects. Such a conclusion, however, requires some strong and unrealistic assumptions. It is assumed, for example, that demand for all consumption goods has the same elasticity with respect to all income earners. Alternatively, if a variation in demand elasticities is allowed for, commodities cannot be taxed at uniform rates.

We are also familiar that the question relating to externalities was effectively emphasised by *Pigou* in his *Study in Public Finance*. Once the existence of externalities is admitted, a case for non-uniform commodity taxation gains credence. Public goods are known to possess externalities in a wide measure and a non-uniform taxation becomes very relevant in their case for bringing an equality between marginal social cost with marginal social benefit. In practice, however, marginal measures are very difficult to estimate. In the discussion of levying taxes to counteract externalities, it is assumed that the state does not need tax revenue for its own sake. In a welfare state, Govt. has to meet its ever increasing expenditure and has to impose even those taxes which distort (rather than improve) resource allocation. This points towards the need for working out an optimal combination of these two types of taxes.[9]