

**Canons of Taxation – Adam Smith’s canons of taxation – equality, economy, certainty and convenience – other canons of taxation**

**CANONS OF TAXATION**

Adam Smith’s was a pioneer in the field of taxation and made notable contributions popularly known as Canons of taxation.

1. Canon of Equality: means the principle of justice, i.e., in accordance to ‘ability to pay’. It means the equality of sacrifice. The amount of the tax paid is to be in proportion to the respective abilities of the taxpayers. For example: Progressive taxation.
2. Canon of Sacrifice: The principle states that tax amount should be in proportion to the respective abilities of the tax payer. The abilities represents the various income levels.
3. Canon of Certainty: prescribes that 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 to be clear and simple to the taxpayer. Uncertainty in taxation encourages insolence or corruption.
4. Canon of Convenience: The tax is to be levied at the time or the manner in which it is most convenient for the taxpayers to pay their dues. For example, Cess has to be collected from the farmers after the principal crops are harvested and marketed.
5. Canon of Economy: It means that the tax will be economical only when the cost of collection is small. Huge and unnecessary administrative costs will make the tax collection an extravagant task.

**Other Canons of Taxation**

1. Fiscal Adequacy or Productivity: The State should meet its expenditure from the revenue raised from the people in the form of taxes. However, the government should not hamper the productive capacity by taxing the community heavily.
2. Canon of Elasticity: The revenue should increase to cater the needs of the State. This is to ensure the government adequate financial resources to meet an emergency situation.
3. Canon of Flexibility: It means that there should be no rigidity in the tax system so that it can be quickly adjusted to new conditions.
4. Canon of Simplicity: This aims at tax which is simple, plain and intelligible to the common understanding. This canon is essential if corruption or oppression is to be avoided.
5. Canon of Diversity: The tax should be a wise admixture of direct and indirect taxes. On the other hand, too great multiplicity will be bad and uneconomical.

6. Social and Economic Objectives: This states that the social and economic objectives of a standard tax system viz., (i) Reduction of inequalities in the distribution of income and wealth, (ii) Accelerating economic growth and (iii) Price stability
7. Canon of Neutrality: Taxation system should be used to control threats of economic instability and stagnation.

**Public expenditure – meaning, need for public expenditure. principles of public expenditure**

**PUBLIC EXPENDITURE**

Public Expenditure aids in employment creation through public works programme thus raising the level of income and employment. It helps in toning down the inequalities of income and wealth distribution in the country.

**Need for Public Expenditure**

1. Social and Economic Overheads: Economic overheads like roads and railways, irrigation and power projects are essential for speeding-up economic development. Social overheads like hospitals, schools, and colleges and technical institutions are essential. Public expenditure has to build up the economic and social overheads.
2. Balanced Regional Growth: Special attention has to be paid to the development of backward areas and under-developed regions to facilitate balanced regional growth. This requires huge amounts for which reliance has to be placed on public expenditure.
3. Development of Agriculture and Industry: Economic development is regarded synonymous with industrial development but agricultural development provides the base and has to be given the priority. Government has to incur lot of expenditure in the agricultural sector, For example: Irrigation and power, seed farms, fertilisers factories, warehouses, etc., and in the industrial sector by setting up public enterprises like the steel plants, heavy electrical, heavy engineering, machine-making factories, etc. All these enterprises are calculated to promote economic development.

4. **Exploitation and Development of Mineral Resources:** Minerals provide a base for further economic development. The government has to undertake schemes of exploration and development of essential minerals, For example:, gas, petroleum, coal, etc. Public expenditure has to play its pivotal role in the exploration and development of mineral resources.

5. **Subsidies and Grants to Provinces, Local Governments, and Exporters:** The central government gives grants to State governments which inturn directs to local governments to induce them to incur some desirable expenditure. Subsidies have also to be given to encourage the production of certain goods especially for export to earn much needed foreign exchange.

### **PRINCIPLES OF PUBLIC EXPENDITURE**

The Principles of Public Expenditure *are*

1. Principle of maximum social benefits
2. Principle of economy, i.e., wasteful expenditure should be avoided
3. Principle of sanction, i.e., authorized expenditure
4. Principle of balanced budget
5. Canon of elasticity, i.e., fairly flexible
6. Avoidance of unhealthy effects on production and distribution

1. Principle of Maximum Social Benefits: According to Dalton, the best system of public expenditure is that which secures the maximum social advantage from the operations which it conducts.

2. Principle of Economy: It means that extravagance and waste of all types should be avoided. Public expenditure has great potentiality for public good but it may also prove injurious and wasteful. If the revenue collected from the taxpayer is heedlessly spent, it would be obviously uneconomical.

To satisfy the principle of economy, it will be necessary to avoid all duplication of expenditure and overlapping of authorities. Further, public expenditure should not adversely affect saving. In case government activity damaged the individual's will or power to save, it would be repugnant to the canon of economy.

3. Principle of Sanction: Another important principle of public expenditure is that before it is actually incurred, it should be sanctioned by a competent authority. Unauthorised spending is bound to lead to extravagance and over-spending. It also means that the amount must be spent on the purpose for which it was sanctioned.

4. Principle of Balanced Budget: Every government must try to keep its budgets well balanced. There should be neither ever-recurring surpluses nor deficits in the budgets. The government, therefore, must try to live within its own means.

5. Principle of Elasticity: Another same principle of public expenditure is that it should be fairly elastic. It should be possible for public authorities to vary the expenditure according to the needs. A fair degree of elasticity is essential if financial breakdown is to be avoided.

6. Avoidance of Unhealthy Effects on Production or Distribution: It is also necessary to see that public expenditure exercises a healthy influence both on production and

distribution of wealth in the community. It should stimulate productive activity so that the volume of production in the country increases and it may be possible to raise the standard of living. The wealth should be fairly distributed.

**Inflation – meaning, definition, types of inflation - demand pull and cost push inflation- comprehensive and sporadic inflation – suppressed and repressed inflation – creeping, walking, running and galloping inflation – mark up inflation**  
**Related concepts of inflation, Rate of inflation**

## INFLATION

Inflation indicates the rise in price of a basket of commodities on a point-to-point basis. It basically suggests an increase in the cost of living over a period of time, For example: 10 essential commodities on 1 st January 2009 for Rs. 100; and the same set of 10 commodities costs Rs. 105 on January 1, 2010; the difference in the price is the inflation rate, that is 5 percent. It means that prices are rising at 5 percent per annum. “Too much money chasing too few commodities” is termed as Inflation.

Inflation may be defined as a persistent and appreciable rise in the general price level. Inflation is statistically measured in terms of percentage increase in the price index over a period of time usually a year or a month.

### **Related concepts of inflation**

1. **Deflation** : A general decline in prices, often caused by a reduction in the supply of money or credit. Deflation can be caused also by a decrease in government, personal or investment spending. The opposite of inflation, deflation has the side effect of increased unemployment since there is a lower level of demand in the economy, which can lead to an economic depression.

2. **Disinflation:** A slowing in the rate of price inflation. Disinflation is used to describe instances when the inflation rate has reduced marginally over the short term. Although it is used to describe periods of slowing inflation, disinflation should not be confused with deflation.
3. **Stagflation** : A condition of slow economic growth and relatively high unemployment - a time of stagnation - accompanied by a rise in prices, or inflation.
4. **Reflation** : A fiscal or monetary policy, designed to expand a country's output and curb the effects of deflation. Reflation policies can include reducing taxes, changing the money supply and lowering interest rates.

### **Types/ Classification of Inflation**

There are several types of inflation in the economy which are classified on different basis. Some of the important types of inflation are discussed below.

1. **Creeping Inflation:** When the rise in prices is very slow (less than 3% per annum) like that of a snail or creeper, it is called creeping inflation. Such an increase in prices is regarded safe and essential for economic growth.
2. **Walking or Trotting Inflation:** When prices rise moderately and the annual inflation rate is a single digit (3% - 10%), it is called walking or trotting inflation. Inflation at this rate is a warning signal for the government to control it before it turns into running inflation.
3. **Running Inflation:** When prices rise rapidly like the running of a horse at a rate of speed of 10% - 20% per annum, it is called running inflation. Its control requires strong monetary and fiscal measures, otherwise it leads to hyperinflation.

4. Galloping or Hyperinflation: When prices rises between 20% to 100% per annum or even more, it is called galloping or hyperinflation. Such a situation brings a total collapse of the monetary system because of the continuous fall in the purchasing power of money.
5. Open inflation: In open inflation, free market mechanism is permitted to fulfill its historic function of rationing the short supply of goods and distribute them according to consumer's ability to pay.
6. Repressed inflation : When the government interrupts a price rise, there is repressed or suppressed inflation. Thus, suppressed inflation refers to those conditions in which price increase are prevented at the present time through adoption of certain measures like price control and rationing by the government, but they rise in future on the removal of such controls and rationing.
7. Mark-up Inflation: This type of inflation resulted from the peculiar method of pricing adopted by the big business organizations. According to this method, the big business organizations calculate their production costs first and then add to these costs a certain mark-up to yield the targeted rate of profit.
8. Comprehensive inflation : When prices of every commodity throughout the economy rise, it is called economy-wide or comprehensive inflation. It is a normal inflationary phenomenon and refers to the rising prices of the general price level.
9. Sporadic inflation : This is a kind of sectional inflation; it consists of cases in which the averages of a group of prices rise because of increase in individual prices due to abnormal shortage of specific goods. When the supply of some goods becomes inelastic, at least temporarily, due to the physical or structural constraints, the sporadic inflation has its way.
10. Profit induced Inflation: During inflation, the entrepreneur class may tend to expect an upward shifting of the marginal efficiency of capital (MEC); hence, entrepreneurs are induced to invest more even by borrowing at higher interest rates. Eventually, investment exceeds savings and economy tends to reach a higher level of money income equilibrium. If economy is operating at full employment level or if there are bottlenecks of market imperfections, real output will not rise proportionately, so the imbalance between money income and real income is corrected through rising prices.

11. Demand-pull Inflation: At the full-employment output, aggregate demand may be greater than aggregate supply, an inflationary gap exists at full-employment level with the price level bid up.
12. Cost-push Inflation: It is caused by an autonomous rise in money wages or other input prices. If producers response by raising prices, it becomes a wage-price spiral.
13. Demand-shift Inflation: Aggregate demand often changes faster than the change on resource allocation. Whenever demand changes, the changes in output may not catch up with the change in demand, the excess demand may lead to inflation, at least in the short run.

### **Measurement of Inflation**

Inflation in India is calculated considering various price index tools.

A price index is a normalized average (typically a weighted average) of prices for a given class of goods or services in a given region, during a given interval of time.

Some notable price indices include Consumer price index, wholesale price index Producer price index and GDP deflator.

**Rate of inflation:** It is defined as the rate of change of the price level as measured by the Consumer price index

$$\text{Rate of inflation in } t^{\text{th}} \text{ period} = \frac{\text{Price level } (t^{\text{th}} \text{ year}) - \text{Price level } (t - 1^{\text{th}} \text{ year})}{\text{Price level } (t - 1^{\text{th}} \text{ year})} \times 100$$

### **Consumer Price Index (CPI)**

Consumer Price Index measures the cost of a fixed basket of products and services. It is a weighted average measure of changes in price of products or services within the basket. The consumer price index is also known as cost-of-living index.

The consumer price basket includes transportation, food and medical care. Large rises in CPI in a short time typically denotes a period of inflation.

$$\text{C P I} (\text{Cost of the bundle in a given period} / \text{Cost of the bundle in the base year} ) \times 100$$

### **Wholesale Price Index (WPI) or Producer Price Index (PPI)**

Wholesale price is the price of representative basket of wholesale goods. Wholesale price index concentrates on price of goods that are transported within corporates rather than consumers. The changes in WPI indicate the price changes in industry which will in turn represent the changes in supply and demand.

Let's calculate the WPI for the year 2009 for a particular commodity. Let's assume that price of a kilogram of wheat in 1993 is Rs 15.00 and in 2009 it is Rs 18.00. The WPI of wheat for the year 2006 is

$$(\text{Price of Wheat in 2009} - \text{Price of Wheat in 1993}) / \text{Price of Wheat in 1993} \times 100$$

$$\text{i.e. } ((18 - 15)/15) \times 100 = 20.$$

Since WPI for the base year is assumed to be 100, WPI for 2009 will be  $100 + 20 = 120$ .

Calculation of Inflation from WPI

The WPI values at two time zones are considered, say, beginning and end of year, the inflation rate of the year can be calculated as

$$(\text{WPI of end of year} - \text{WPI of beginning of year}) / \text{WPI of beginning of year} \times 100.$$

### **The GDP or GNP Deflator**

It is an index of the prices of all final goods and services constituted the GDP or GNP.

$$\text{GDP Deflator} = (\text{Nominal GDP} / \text{Real GDP}) \times 100$$

### **Food inflation**

The food price inflation in the country can be attributed to low growth in food grain production, low competition and poor integration of supply over time and space. The remedial measures therefore include increase in domestic production and imports, and promote competition in food markets.

**Causes of inflation – Remedial measures – monetary – fiscal measures.**

**Causes of Inflation – Remedial measures**

Broadly speaking inflation arises when the aggregate demand exceeds the aggregate supply of goods and services. The factors which lead to increase in demand and the shortage of supply are discussed.

**Factors Causing Increase in Demand:**

1. **Increase in Money Supply:** Inflation is caused by an increase in the supply of money which leads to increase in aggregate demand. The higher the growth rate of nominal money supply, the higher is the rate of inflation.
  2. **Increase in Disposable Income:** When the disposable income of the people increases, it raises their demand for goods and services. Disposable income may increase with the rise in national income or reduction in taxes or reduction in the saving of the people.
  3. **Increase in Public Expenditure:** In modern world government activities have been expanding which resulted in increase government expenditure. This raised the aggregate demand for goods and services, thereby causing inflation.
  4. **Increase in Consumer Spending:** The demand for goods and services also increases when consumer spending increases due to conspicuous consumption or demonstration effect.
  5. **Cheap Monetary Policy:** Cheap monetary policy or the policy of credit expansion also leads to increase in the money supply which raises the demand for goods and services in the economy thereby leading to inflation. This is also known as credit-induced inflation.
  6. **Deficit Financing:** In order to meet its mounting expenses, the government resorts to deficit financing by borrowing from the public and even by printing more notes. This raises aggregate demand in relation to aggregate supply, thereby leading to inflationary rise in prices.
  7. **Increase in Exports:** When the demand for domestically produced goods increases in foreign countries, this raises the earnings of industries producing export commodities. These, in turn, create more demand for goods and services within the economy.
- Apart from the above factors, expansion of the private sector, existence of black money and the repayment of public debt by the government also increases the aggregate demand for goods and services in the economy.

**Factors Causing Shortage of Supply:** Following are the factors which result in a reduction in the supply of goods and services:

1. **Shortage of factors of production:** When there is shortage of factors of production like labour, capital, raw materials, etc. there is bound to be reduction in the production of goods and services.
2. **Industrial Disputes:** In countries where trade unions are powerful, they resort to strikes and lock-outs which resulted in a fall in industrial production thereby reducing the supply of goods.
3. **Natural Calamities:** Natural calamities like droughts, floods, etc. adversely affects the supplies of agricultural products. This creates shortage of food products and raw materials, thereby helping inflationary pressures.
4. **Artificial Scarcities:** Artificial scarcities are created by hoarders and speculators who indulge in black marketing. Thus, they are instrumental in reducing supplies of goods and raising their prices.
5. **Increase in Exports:** When the country produces more goods for exports than for domestic consumption, this creates shortages of goods in the domestic market. This leads to inflation in the economy.
6. **Lop-sided production:** If the stress is on the production of comforts, luxuries, or basic products to the neglect of essential consumer goods in the country this creates shortages of consumer goods. This again causes inflation.
7. **Law of Diminishing Returns:** If industries in the country are using old machine and outmoded methods of production, the law of diminishing returns operates. This raises cost per unit of production, thereby raising the prices of products.
8. **International Factors:** In modern times, inflation is a worldwide phenomenon. When prices rise in major industrial countries, their effects spread to almost all countries with which they have trade relations. Often the rise in price of a basic raw material like petrol in the international market leads to rise in the price of all related commodities in a country.

#### Measures to control Inflation

Inflation is caused by the failure of aggregate supply to equal the increase in aggregate demand. The various measures to control inflation are:

#### **Monetary Measures**

(a) **Credit Control:** The central bank could adopt a number of methods to control the quantity and quality of credit to reduce the supply of money. For this purpose, it raises the bank rates, sells securities in the open market, raises reserve ratio, and adopts a number of selective credit control measures, such as raising margin requirements and regulating consumer credit.

(b) **Demonetisation of Currency:** Another monetary measure is to demonetise currency of higher denominations. Such a measure is usually adopted when there is abundance of black money in the country.

(c) Issue of New Currency: The most extreme monetary measure is the issue of new currency in place of the old currency. Under this system, one new note is exchanged for a number of the old currency. Such a measure is adopted when there is an excessive issue of notes and there is hyperinflation in the economy.

### **Fiscal Measures**

(a) Reduction in Unnecessary Expenditure: The government should reduce unnecessary expenditure on non-development activities in order to curb inflation.

(b) Increase Taxes: To cut personal consumption expenditure, the rates of personal, corporate and commodity taxes should be raised and even new taxes should be levied, but the rates of taxes should not be too high as to discourage saving, investment and production.

(c) Increase in Savings: Another measure is to increase savings on the part of the people so that their disposable income and purchasing power would be reduced. For this the government should encourage savings by giving various incentives.

(d) Surplus Budgets: An important measure is to adopt anti-inflationary budgetary policy. For this purpose, the government should give up deficit financing and instead have surplus budgets. It means collecting more in revenues and spending less.

(e) Public Debt: In addition, the government should stop repayment of public debt and postpone it to some future date till inflationary pressures are controlled. Instead, the government should borrow more to reduce money supply with the public.

Other measures to control inflation generally aims at increasing aggregate supply and reducing aggregate demand directly. These are :-

(a) Increase production.

(b) Rational Wage Policy:

(c) Price Control: Price control and rationing is another measure of direct control to check inflation. Price control means fixing an upper limit for the prices of essential consumer goods.

(d) Rationing:

(e). Enhance imports