INTRODUCTION, ORIGIN AND NEED OF TAXATION

Chapter 1

INTRODUCTION

"In this world, nothing can be said to be certain, except death and taxes."

-Benjamin Franklin[1]

Benjamin Franklin beautifully quoted the importance of taxes in human life. Definitely taxes are certain and no one can escape from taxes. Modern civilization depends upon tax administration and one who manages the web of taxes have key to rule people. Taxation is compulsory on the part of the government. The government receives taxes from the national and foreigner, those who are doing business in their home country in order to make good profit. So government collects taxes and put in on different projects for their people.

"It was only for the good of his subjects that he collected taxes from them, just as the Sun draws moisture from the Earth to give it back a thousand fold"

– Kalidas in Raghuvansh eulogizing King Dalip[2]

The king Dalip was a wise king; he knew the importance of tax and its effects. Poor people cannot bear heavy taxes and it has been seen that heaver taxes lead to tax evasion and stock of black money. Therefore taxes should be reasonable and progressive in nature that people don't feel pinch of taxes. It is duty of the king to make good tax system to raise more revenue only to help people.

As we knew government has to perform multiple operations which are vital for a sovereign nation and betterment of the people. There is one question widely asked by the people, why taxes are so much important? Answer is not typical; as we know government has responsibility to protect life and property of citizens and has to facilitate those services which are necessary for doing economic activity within and outside the nation. As we know the term property exists only in sovereign country where security is guaranteed by the government to the owner of the property and in return owner of property pays taxes to the state.

Taxes were present from the very beginning of human civilization, when people started to live in groups. Taxes were common in the state theories given by Hobbs, Lock and Russo. People governed have to give taxes to the ruler for the protection of their property and life. Later ruler started to provide services; which helped people to do progressive economic activities, now ruler provide basic infrastructure that helped people multiple fold and it also increased revenue collection. There are some laws (initially in the form of Darma) ruler must follow in case if he does not follow, people had right to raise demand for his removal from the kinghood. So it was will of people that prevail in normal times.

Definition of Tax: The word tax is derived from the Latin word 'taxare' meaning 'to estimate'. The term "Tax" is no where defined in Indian Constitution. Supreme Court of India has approved definition of "Tax" given by Australian High Court in the famous case, *The*

[1] As certain Death and taxes (rates) Franklin 1789.

[2] Raghuvansh by Kalidas

Commissioner, Hindu Religious Endowments, Madras vs Sri Lakshmindra Thirtha Swamiar, 1954[3] is "A tax is a compulsory exaction of money by public authority for public purposes enforceable by law and is not payment for services rendered."

"A tax is not a voluntary payment or donation, but an enforced contribution, exacted pursuant to legislative authority" and is any contribution imposed by government whether under the name of toll, tribute, impost, duty, custom, excise, subsidy, aid, supply, or other name." (Black's Law Dictionary)[4]

According to article 265 of Indian Constitution, No Taxes can be levied or collected except authority of law. Mo tax can be imposed by the executive order. The law providing for imposition of tax must be a valid law.[5] By this way Tax is compulsory extraction of money by public authority and it is enforceable by law. It is not charge for any kind of services. It provides benefit to all people in the form of government policies. It is not possible to formulate a definition of fee that can apply to all cases as there are various kinds of fees. But a fee may generally be defined as a charge for a special service rendered to individuals by some governmental agency. The amount of fee levied is supposed to be based on the expenses incurred by the Government in rendering the service, though in many cases such expenses are arbitrarily assessed. The distinction between a tax and a fee lies primarily in the fact that a tax is levied as part of a common burden, while a fee is a payment for a special benefit or privilege."

D.G. Ghosh vs State of Kerela, 1980[6], The Court cannot for "obvious reasons meticulously scrutinize" the burden of taxation on different persons and interests. Certain advantages or disadvantages are accidental and unavoidable and are inherent in every law imposing a tax because such law "has to draw a line somewhere and some cases necessarily fall on the other side of the line".

The aggregate of all sum collected by government is called its **Revenue**; the system by which it is collected is called '**Taxation**".

"The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing." ...Colbert[7]

The aggregate of all sums collected by government is called its Revenue; the system by which it is collected is called Taxation. Although the single object of taxation is to obtain a given amount of wealth (generally in the form of money), yet the modes by which that object may be secured are various.

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[3] The Commissioner, Hindu Religious Endowments, Madras vs Sri Lakshmindra Thirtha Swamiar, 1954 AIR 282, 1954 SCR 1005.

[4] Blacks law Dictionary

[5] M/s. Chhotabhai v. Union of India, AIR 1962 sc 1006.

[6] D.G. Ghosh and Co. vs State of Kerala, A.I.R. 1980 S.C. 271.

[7] Jean Baptiste Colbert (French Economist and Minister of Finance under King Louis XIV of France. 1619-1683) He carried out the program of economic reconstruction that helped make France the dominant power in Europe.

Funds provided by taxation have been used by states and their functional equivalents throughout history to carry out many functions. Some of these include expenditures on war, the enforcement of law and public order, protection of property, economic infrastructure (roads, legal tender, enforcement of contracts, etc.), public works, social engineering, and the operation of government itself. Most modern governments also use taxes to fund welfare and public services. These services can include education systems, health care systems; pensions for the elderly, unemployment benefits, and public transportation. Energy, water and waste management systems are also common public utilities. Governments use different kinds of taxes and vary the tax rates. This is done to distribute the tax burden among individuals or classes of the population involved in taxable activities, such as business, or to redistribute resources between individuals or classes in the population.

The theory that underlies taxation is that charges are imposed to support the government in exchange for the general advantages and protection afforded by the government to the taxpayer and his or her property. The existence of government is a necessity that cannot continue without financial means to pay its expenses; therefore, the government has the right to compel all citizens and property within its limits to share its costs. The state and federal governments both have the power to impose taxes upon their citizens.

ORIGIN

At the beginning of human occupation of this planet, men lived in small roaming bands as "food gatherers" and families were free from tax. It was when man learned to plant grain that the situation of land ownership developed. The landholders organised themselves into communities in self-defence against predatory animals and other roaming bands. This meant that every family had to make some contribution to support the community effort. This contribution was, in our present understanding of the situation, a form of taxation. As agriculture developed, man had more time for arts and crafts, for spiritual awareness, for the development of small industries, all of which led to transfer of authority in the realm of communal good to a chief selected by the community. This leader expected remuneration; consequently a type of "tax" was imposed on the members of the community for his support.

With the advent of the years and subsequent growth of communities, now function of these communities become more and more complex and it required more tax to support ancillary services i.e. building infrastructure for better economic activities, now leader of these communities have to perform multiple work i.e. protection of their people from external aggression and save their life and property, maintenance of law and order within the his state. Building friendly relation with the neighbour states for promotion of trade and commerce; promotion of education and art, and entertainment services i.e. dancing, singing, wrestling and sport activities. These activities need more funds thus very first time ruler worked on tax planning. Now big states are in vogue and king had group of minister to help him taking decision on important matter. Finance minister of the state had responsibility of tax management.

In ancient times, taxation was often imposed by the arbitrary fiat of the ruler, with little or no reference to equity, or its effect on the prosperity and happiness of the people; thus some rulers became greedy for power, and therefore they imposed so heavy a tax that it became a burden on the people. Populations grew that were born into serfdom, wherein man was beholden to his authority figures. During the approximately 3,000 years of control by chiefs, landlords and kings who held their subjects obligated to pay tax, a man often paid with his labour and skills when currency was a scarce commodity. Even today, segments of the population within our society are charged for their labour and skills and they pay rent on the land they lease. It is understandable therefore, that taxation today has developed into a multiplicity of levies, taxes and tithes, all of which overwhelm the common ordinary citizen. A good example of today's complex taxation system comes in the form of licenses, customs duties, road tax, sales tax, luxury tax, service tax and many, many others. Over and above all forms of taxation, that which causes the most concern to the ordinary citizen of the country is direct tax i.e. income tax. The question of taxation, in its various bearings, is now made the subject of examination and discussion in all legislative bodies; and taxes are imposed, in all constitutional governments, not at the caprice of the ruler, but by the representatives of the people.

NEED OF TAXATION

Government and social organization are among wants of man, as truly as food, clothing and abode. Government needs revenue to perform their functions which are vital for people to live life with dignity. History is witness of miserable life of people in weak states. The great Indian scholar Kautilya popularly known as Chanakya said “"From the treasury, comes the power of the government, and the Earth whose ornament is the treasury, is acquired by means of the Treasury and Army". The statement made by Chanakya is very much true, a strong nation can better protect rights of its citizen and it is treasury from where comes the power and the treasury of the state depends upon good tax planning and people's trust in the government to pay taxes honestly to make their state stronger.

It is duty of the government to aware people about state's welfare schemes, therefore now modern government advertise their public policies and program to have public confidence and this social engineering work as catalyze to pay taxes to government in due time. Publications Division of the Ministry of Information and Broadcasting advertise government planning and schemes that people take maximum benefit of government planning and schemes. It is one of the most important works of the government to advertise its policies.

As we know Treasure is the source of power for the government therefore government should prepare good taxation system to take maximum advantage of economic resources of the country but the same time taxes should not be excessive and complicated; if no it will lead people to start tax evasion, which is not good for health of a nation.

Taxes are important for the growth of nation; it helps to protect people from war i.e. people are better safe in strong nation than weak nation and we know power comes from the treasury. It helps the state to maintain law and order within the state, government take impose high taxes on alcohol, tobacco etc such heavy taxes are known as evil taxes e.g. it has been seen after taking liquor people break law and order system therefore they have to pay for it therefore government has imposed heavy taxes to reduce consumption of such things to maintain law and order in the state. Expenditure on infrastructure helps the state many fold and we can see its positive results immediately and after a long time as well. Those countries where government got success to build strong infrastructure are now develop countries or emerging as one of fastest growing counties of the world. Taxes help the government to spend on social security programs and welfare schemes. Benefits of effective taxation system are endless.

It is public will that prevail in democratic system. Legislation is one of the most difficult and delicate work to perform especially when it comes to legislate on financial matters. To introduce a new tax or to increase tax rate (especially in direct taxes – Income tax) is never being an easy task for the government. It is quite clear that government need money to perform its respective duties. Often government fails to make aware people about importance of tax and its direct nexus with the development of the state. At the very beginning of a new democratic system government were in need of money to build infrastructure to walk on path of progress therefore government had to take public property for public purposes but that days has gone by, probably not soon to return. If, then, the property of the citizen must be taken to meet the exigencies of government, it becomes highly important that those from whom it is taken should feel that it is equitably done. Nothing in relation to all the acts of government is more to be desired than that its mode of raising revenue should be so wisely and economically arranged, so manifestly just and equal, and so well understood by all, that no opposition to its demands shall arise from a sense of oppression.

There is no force superior to the public will, and where it is certain do taxes can be collected but such as are believed to be both necessary and just. In the distribution of wealth, as has been before stated, government makes a peremptory claim to so much as its necessities, real or supposed, may require. This claim is not only peremptory, but prior to every other claim. The laborer must contribute a part of his wages; the business man, of his profits; and the capitalist, of his interest, or rent. Every man knows, or should know, that when he creates any kind of wealth, a share of it belongs to government. He, in fact, creates a fund out of which government is to be supported.

Taxation has four main purposes or effects:

1. Revenue
2. Redistribution
3. Repricing and
4. Representation.

Revenue: The main purpose of taxes is to collect revenue, and revenue funds to spend on roads, schools, hospitals, and on other indirect government functions like market regulation or legal systems.

The tax revenue is the sum of the revenues of different kind of taxes, depending on what is taxed:
1. The revenue of physical and juridical persons ("direct taxes").
2. Wealth and assets as real estates and houses.
3. The domestic economic transactions ("indirect taxes" - e.g. VAT).
4. International trade, typically through import duties.
5. Financial transactions, both in domestic and in international terms.

Determinants
Tax revenue is the result of the application of a tax rate to a tax base.
Taxes are ranked according to the tax rate:
1. Progressive taxes, with a tax percentage rate growing with the amount taxed.
2. Proportional taxes, with a tax rate constant whatever the tax base.
3. Regressive taxes, with falling tax rate whilst increasing base.

4. Lump sum taxes, with a fixed absolute value of the tax, irrespective of the tax base.

Thus, the income distribution and tax base dynamics are key determinants for the revenue from progressive, proportional and regressive taxes, whereas it becomes irrelevant for lump sum taxes.

Fiscal systems differ a lot throughout the world but usually the personal revenue tax is progressive, the firm revenue tax is proportional as well as the taxation of domestic and international economic activity. Also wealth taxation is usually proportional, with some use of lump sums.

Redistribution: The second purpose is redistribution, which means transferring wealth from the richer sections of society to poorer sections.

"It lies in the nature of things that the beginnings are slight, but unless great care is taken, the rates will multiply rapidly and finally will reach a point that no one could have foreseen"
...F. Guicciardini[8]

Redistribution of income and wealth or redistribution of wealth is the transfer of income, wealth or property from some individuals to others caused by a social mechanism such as taxation, monetary policies, welfare, charity, and divorce or tort law.[9]

"Money is like muck, not good except it be spread"
...Francis Bacon[10]

Today, income redistribution occurs in some form in most democratic countries. In a progressive income tax system, a high income earner will pay a higher tax rate than a low income earner.

Two common types of governmental redistribution of wealth are subsidies and vouchers (such as food stamps). These "transfer payment" programs are funded through general taxation, but disproportionately benefit the poor, who pay fewer or no taxes. While the persons receiving redistributions from such programs may prefer to be directly given cash, these programs may be more palatable to society, as it gives society some measure of control over how the funds are spent.[11]

Repricing: A third purpose of taxation is repricing of certain goods to increase or decrease their consumption. Taxes are levied to discourage consumption of certain items like say tobacco. Taxes on alcohol, coffee, fast foods, soft drinks candies and tobacco are also known as sin tax, a kind of sumptuary tax levied on certain socially proscribed goods and services.

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[8] F. GUICCIARDINI (ca. 1538)[8]

[9] "Redistribution". Stanford Encyclopedia of Philosophy. Stanford University. 2 July 2004.

[10] Francis Bacon, 'Of seditions and Troubles', Essays

[11] Harvey S. Rosen & Ted Gayer, Public Finance p. 271-72 (2010)

Sin Tax: A state-sponsored tax that is added to products or services that are seen as vices, such as alcohol, tobacco and gambling. These type of taxes are levied by governments to discourage individuals from partaking in such activities without making the use of the products illegal. These taxes also provide a source of government revenue.[12]

Sin taxes are typically added to liquor, cigarettes and other non-luxury items. State governments favor sin taxes because they generate an enormous amount of revenue and are usually easily accepted by the general public because they are indirect taxes that only affect those who use the products. When individual states run deficits, the sin tax is typically one of the first taxes recommended by lawmakers to help fill the budget gap.

The revenue generated by sin taxes is sometimes used for special projects, but might also be used in the ordinary budget. American cities and counties have used them to pay for stadiums, while in Sweden the tax for gambling is used for helping people with gambling problems. In many countries tax for alcohol and tobacco is used to maintaining law and order in the state. Acceptance of sumptuary taxes may be greater than income tax or sales tax

Representation: the citizens by paying taxes demand accountability in return from the government. Several studies have shown that direct taxation (such as income taxes) generates the greatest degree of accountability and better governance, while indirect taxation tends to have smaller effects. There are consumer interest protection groups in Europe and America to protect interest of people and they represent them before the government and bargain with the government in the matter of indirect taxes. It has been seen if government arbitrary increase indirect which diversely affect interest of consumers they start mass boycott of that commodity to make pressure on the government to rethink on government’s indirect taxation policy.

If citizen pay taxes honestly it will increase sense of patriotism also and therefore they ask to government about their fiscal policies and it helps democratic system to flourish. After all democracy is all about peoples active participation in the governments affairs, if it increases it means that democratic system is active in real sense.

NATURE OF TAXATION

The power to tax is an attribute of sovereignty, exercised by the government for the betterment of the people within its jurisdiction whose interest should be served, enhanced and protected.[13]

It is an inherent power of sovereignty, essentially a legislative function, enforced for public purpose, operates only within its territorial jurisdiction, exempts government agencies from tax and is subject to constitutional and inherent limitations. Art 265 of the constitution of India clear that no tax can be withdrawn without authority of law. It is work of the legislature to legislate for public welfare but there is invisible line not to cross by the courts in the

[12] Investopedia dictionary (2013)

[13] (69 SCRA 460)

financial matters of the government. But the same time it is public will that prevail at the end, and we have seen it is general elections of the country.

Article 246 of the Constitution of the India define Subject-matter of laws made by Parliament and by the Legislatures of States, and for the convenience of the government operations and to remove future ambiguity all subjects has been divided into three lists one is the union list having 97entries, second one is States list having 66 entries and third and the last one is Concurrent list having 47 entries. Residuary subject falls under entry 97 of the Union list.

In order for a tax system to operate effectively, certain principles must be put in place.

Fairness: the tax must be fair, that is, citizens should be taxed in proportion to their abilities to pay.

Clarity and Certainty: Convenience: the application of a tax should be clear and certain. If the application is uncertain and arbitrary the public can have no confidence in the system. Compliance with tax laws may increase if it is easy and convenient.

Efficiency: a good tax system should be structured so that it can be administered efficiently and economically. Taxes that are difficult or costly to administer divert resources to nonproductive uses and diminish confidence in both the levy and the government.

In the past taxation was regarded solely as a means to finance the necessary obligations of a government. The money was used to pay elected officials, maintain state security, build roads, bridges and public buildings; and pay for such services as schools, hospitals and fire fighters. In recent times, the purposes of taxation have expanded considerably, as have the roles of governments in society.

Taxes have three main functions at present scenario. First and foremost, to provide the money that makes it possible for government to function. Second, taxes have an economic significance: they are used to promote goals such as full employment, satisfactory rates of economic growth, and stability of the money supply. The economic goals of taxation are achieved by raising or lowering tax rates. The fewer taxes people pay, the more they have for their personal use. Conversely, the more taxes they pay, the less money they have available for themselves. Third, taxes are used as a redistribution of wealth. The purpose of income redistribution is to lessen the inequalities of wealth in society. This is done through what is called a system of transfer payments. The effect of the system is to transfer money from those who have a good deal of it to those who have very little. Two of the most common examples are social security payments and welfare payments made to people who, for one reason or another, do not work

TAXATION STRUCTURE

The sum of all taxes is called revenue and taxes are divided in two broad category first one is direct taxes and indirect taxes. All taxes fall either in direct taxes or indirect taxes. Direct taxes are paid on income. Direct taxes are progressive in mature it means that the more income you earn the greater your contribution is expected to be to the state. Direct taxes are more reliable than indirect taxes as government have clear figure of assesses to calculate future income but in case of indirect taxes government cannot fully rely on future income through indirect taxes. Indirect taxes are levied on expenditure and generally regressive in nature indirect taxes are imposed on the basis of the individual consumption, the individual pays only on what he consumes. However, it must be noted that taxation is used not only to raise revenue but also to regulate consumption and may even be used to curtail various forms of business activities. For instance, alcoholic beverages and tobacco may be taxed heavily on the grounds that their use is hazardous to the health of individuals. Such revenue, often called a “sin tax”, is infect, a penalty paid by the users of the substance.

The regulatory aspects of taxation are more apparent in indirect taxes, such as customs duties and taxes, than in direct taxes such as income tax. For instance, government can control private consumption, especially of imported goods, by increasing customs tariffs. An increase in taxation on personal income on the other hand, may result in a decrease in private savings without affecting the level of consumption.

The effectiveness of any government depends on the willingness of the people governed to surrender or exchange a measure of control over their persons and property, in return for protection and other services. Taxation is one form of this exchange. In designing tax systems, governments customarily consider three basic indicators of taxpayer wealth or ability to pay: what people own, what they spend, and what they earn. The kinds of taxes raised by government for revenue are numerous. The most common are: personal income taxes, corporate income taxes, property taxes, sales taxes, death and gift taxes, and import-export duties.

We can classify taxes according to their nature. Some popular taxes are given below:

- **Progressive Tax**
- **Regressive Tax**
- **Proportional Tax**
- **Lump-sum tax**
- **Ghetto Tax**

Before discussing above taxes one must know what is Marginal Rate of Tax and Average Rate of Tax.

Marginal Rate of Tax: tax rate applied to an incremental amount of income. Think of this as the rate that will be applied to the next dollar of income. The concept of marginal tax will be important throughout the course in evaluation the rate on income and the tax savings associated with a particular deduction. Most tax planning is based upon the marginal rate.

Average Rate of Tax: The total amount of taxes paid by an individual or business divided by taxable income; this rate will vary based on the amount of income received during the taxable period. For example, if john paid $3,000 in taxes on income of $25,000, his average tax rate would be 12%.

$$\text{Average tax rate} = \frac{\text{Paid taxes}}{\text{Taxable income}}$$

Progressive tax: The earliest known application of progressive taxation took place in Great Britain in the 14th century. In the United States, the first progressive income tax was established by the Revenue Act of 1862, which was signed into law by President Abraham Lincoln and repealed the short-lived flat tax contained in the Revenue Act of 1861.

Progressive tax policy is based on the simple idea that people with more money should pay more in taxes, and people with a lot more money should pay a lot more. It is fair that people who have benefited most from the opportunities provided by our public institutions should contribute in order to keep our society livable. The term "Progressive" describes a distribution effect on income or expenditure, referring to the way the rate progresses from low to high, where the average tax rate is less than the marginal tax rate.[14] It can be applied to individual taxes or to a tax system as a whole; a year, multi-year, or lifetime. Progressive taxes attempt to reduce the tax incidence of people with a lower ability-to-pay, as they shift the incidence increasingly to those with a higher ability-to-pay.

Slightly restructuring the income tax so that the wealthiest people pay a fair share of their income is the best way to bring revenue to the state so that people have the quality public services people need and deserve. The top one per cent of income earners will not be hurt by paying a fraction more, and the billions in income brought to the state will provide smaller class sizes, safer neighborhoods, and public health measures that keep people all healthier.

Taxation has four main purposes or effects: Revenue, Redistribution, Repricing, and Representation. Progressive taxation is reliable source of income as government knows how many assessee there in the state and how much revenue can be generate through direct taxes. Redistribution is one of the most important feature of progressive taxation, redistribution means taking more money from the rich people and to distribute it to poor in the form of government policies and programs and lastly representation direct taxes fix greater degree of responsibility towards the taxpayers of the state and it also helps to increase sense of patriotism as one who pays direct taxes feels that he has done something for the country. it is responsibility of the government to do work for betterment of their people so people feel that taxes paid by them is spending on right direction and it helps the government to successfully operate their functions.

“God did not create all of us equal; he created some more equal than others”

.... Anon

Redistribution follows laws of natural justice and based on principles of equity. Taxation is based on the maxim “equality of sacrifice”. Equality of scarifies can be justified only when we apply progressive taxation in our society but in case of indirect taxes, there are practical difficulties to implement it but in case of direct taxes we can easily apply it, we can treat people equal only if are equal in status. People who have similar income have to pay equal amount in the form of income tax. Equality of scarifies means taxpayers should feel equal amount of burden in the form of taxes. People with more income pay a higher percentage of that income in tax than do those with less income. It can also apply to adjustment of the tax base by using tax exemptions, tax credits, or selective taxation that creates progressive distribution effects.

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[14] Sommerfeld, Ray M., Silvia A. Madeo, Kenneth E. Anderson, Betty R. Jackson (1992), *Concepts of Taxation*, Dryden Press: Fort Worth, TX

Progressive taxation means that **MRT > ART** [if you are pedantic, if MRT (Marginal Rate of Tax) and ART (Average Rate of Tax) do not equal zero]. For example, in India there are three rates of income tax - 10% 'starting tax', 20% 'standard tax', and 30% high rate of tax. For a low income earner, ART will be around 10-20%, whereas a very high income earner will pay more like 30% ART. Thus, higher income earners pay a greater proportion of their income in tax than low earners.

Regressive tax: A tax that takes a larger percentage from low-income people than from high-income people. A regressive tax is generally a tax that is applied uniformly. This means that it hits lower-income individuals harder.[15]

Some examples include excise tax and service tax. For example, if a person has Rs.10 of income and must pay Rs.1 of tax on a packet of bread, this represents 10% of the person's income. However, if the person has Rs.20 of income, this Rs.1 tax only represents 5% of that person's income.

Excise taxes that apply to essentials are generally considered to be regressive as well because expenses for food, clothing and shelter tend to make up a higher percentage of a lower income consumer's overall budget. In this case, even though the tax may be uniform (such as 5.5%. sales tax), lower income consumers are more affected by it because they are less able to afford it.

A regressive tax is a tax imposed in such a manner that the tax rate decreases as the amount subject to taxation increases. "Regressive" describes a distribution effect on income or expenditure, referring to the way the rate progresses from high to low, where the average tax rate exceeds the marginal tax rate. In terms of individual income and wealth, a regressive tax imposes a greater burden (relative to resources) on the poor than on the rich. There is an inverse relationship between the tax rate and the taxpayer's ability to pay as measured by assets, consumption, or income.

The regressivity of a particular tax often depends on the propensity of the taxpayers to engage in the taxed activity relative to their income. In other words, if the activity being taxed is more likely to be carried out by the poor and less likely to be carried out by the rich, the tax may be considered regressive. To determine whether a tax is regressive, the income elasticity of the good being taxed as well as the income substitution effect must be considered.

Proportional tax: The French Declaration of the Rights of Man and of the Citizen of 1789 proclaims: A common contribution is essential for the maintenance of the public forces and for the cost of administration. This should be equitably distributed among all the citizens in proportion to their means.[16]

Proportional tax is a tax in which the tax rate remains constant regardless of the amount of the tax base.[17] A proportional tax is a tax imposed so that the tax rate is fixed, with no change

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[15] Investopedia Dictionery - 2013

[16] Declaration of the Rights of Man - 1789

[17] Webster Dictionary

as the taxable base amount increases or decreases. The amount of the tax is in proportion to the amount subject to taxation.[18]

Proportional tax is also called flat tax. Tax rate is same for all taxpayers, regardless of level of income. Proportional tax system requires the same percentage of income from all taxpayers regardless of their earnings. A proportional tax applies the same tax rate across low, middle and high-income taxpayers. The proportional tax is in contrast to a progressive tax, where taxpayers with higher incomes pay higher tax rates than taxpayers with lower incomes.[19] A proportional tax is also called a flat tax.

For example, in a proportional tax system, all taxpayers may be required to pay 10% of income in taxes. A sales tax can be considered a type of proportional tax since all consumers, regardless of earnings, are required to pay the same fixed rate.

The term "Proportional" describes a distribution effect on income or expenditure, referring to the way the rate remains consistent (does not progress from "low to high" or "high to low" as income or consumption changes), where the marginal tax rate is equal to the average tax rate.[20] It can be applied to individual taxes or to a tax system as a whole; a year, multi-year, or lifetime. Proportional taxes maintain equal tax incidence regardless of the ability-to-pay and do not shift the incidence disproportionately to those with a higher or lower economic well-being.

A proportion form of taxation to many seems quite fair as individuals pay according to their ability to pay. One point of view is that for the rich, based on the different high incomes, it is easier to pay off taxes because a smaller proportion of their income is spent on necessities. They therefore have more disposable income to spend on other goods/services also to invest within capital goods which said before may stimulate and benefit the welfare of the economy. Some may say that this system promotes a more fair and just society. Equity of taxation in this economy can be neutral. Increases in labor, increases wages thereby increases income-taxes. The con for this system is that the government would receive less income tax. Less income tax therefore means that less would be available for government spending.

The French Declaration of the Rights of Man and of the Citizen of 1789 proclaims: A common contribution is essential for the maintenance of the public forces and for the cost of administration. This should be equitably distributed among all the citizens in proportion to their means.[21]

Proportional taxation means that **MRT = ART**, so if a low income earner is taxed at 20%, so is a higher income earner. The proportion of tax paid is always the same, though in absolute terms it goes up the higher your income.

[18] Sommerfeld, Ray M., Silvia A. Madeo, Kenneth E. Anderson, Betty R. Jackson (1992), Concepts of Taxation, Dryden Press: Fort Worth, TX

[19] Investopedia Dictionary

[20] Hyman, David M. (1990) Public Finance: A Contemporary Application of Theory to Policy, 3rd, Dryden Press: Chicago, IL

[21] Declaration of the Rights of Man - 1789

Some people consider it as regressive tax as it affects low income group people, as low income group people spend much money on daily utilities as food, medicine etc and spend large part of their income on it and pays proportionally more tax than those who have large income but do not spend proportionally large part of their income on daily utilities therefore they pay proportionally less tax than those who have low income.

Lump-sum tax: A lump sum tax is a tax with a fixed amount that is levied on all members of a society regardless of their income levels. Each member of the society, from the richest to the poorest, is charged the same lump sum when such a tax exists. Instances of an actual lump sum tax are rare in reality, since the tax would be excessively burdensome to the poorer members of a society. The theory of a lump sum tax is often used by economists as a means of studying the ways that an economy can be more efficient. Many economists argue that charging a lump sum would be a more effective method of aiding an economy. Whereas a tax based on income might cause some workers to work at less than their maximum capability for fear of paying higher taxes, proponents of the lump sum argue that a fixed-amount tax would not impede workers' motivation in any way.

As the lump-sum is negotiable, the tax authorities are free to set the taxable amount in the negotiations to a different and even higher amount. Factors that play a role are your total global wealth, age, family situation and the municipality in which the taxpayer will live. Individual taxes are usually levied depending either on the amount of income they earn or the amount of some particular product that they consume. It's usually the case that the people who make the most money in a society are taxed at the highest percentage of their income since they can afford it. Those taxes often are used in turn to benefit the poorer people in an economy. By contrast, a lump sum tax is levied upon every single member of a single society.

It is one of the various modes used for taxation: income, things owned (property taxes), money spent (sales taxes), miscellaneous (excise taxes). It is a regressive tax, such that the lower the income is, the higher the percentage of income applicable to the tax. An example is a poll tax to vote, which is unchanged no matter what the income of the voter. Other related examples include personal property taxes on cars or business equipment regardless of income or ability to pay. Real estate taxes that are levied on a per lot or per unit basis are another example; some condominium fees could be regarded as having most of the characteristics of a lump sum tax (other than being avoidable by not owning property in a condominium).

In economic theory, a lump-sum tax may have the advantage of not contributing to an excess burden of taxation, a loss in economic efficiency that results from taxes reducing incentives for production. In practice, lump-sum taxes are often encountered, in spite of their conflict with other criteria, such as equity or ability to pay. A lump-sum tax remains a standard for measuring the performance of other imperfect kinds of taxes (J. de V. Graaf, 1987)[22]

An example of a lump-sum tax is a $55 fee on all employees who work in a township. Another example is tag fees on vehicles, which are the same regardless of the income of vehicle owners. Lump-sum taxes are regressive, meaning persons with lower income pay more as a percentage of their income.

[22] J. de V. Graaf (1987, 2008). "lump sum taxes," The New Palgrave: A Dictionary of Economics, v. 3, pp. 251-52.

Ghetto Tax: Exploitation of poor people and minorities in the form of price markups on goods and services. For example, higher rates for insurance, usury in loan rates, and "vending machine" level prices from the corner store. The study, from the Brookings Institution, said finding ways to eliminate these added costs, often called a “ghetto tax,” could be an important new front in the fight against poverty.[23] Poor urban residents frequently pay hundreds if not thousands of dollars a year in extra costs for everyday necessities. The study said some of the disparities were due to real differences in the cost of doing business in poor areas, some to predatory financial practices and some to consumer ignorance. A ghetto tax is not literally a tax; it is a situation in which people pay higher costs for equivalent goods or services simply because they are poor, or live in a poor area.

In public policy, a euphemism for the higher price of many goods and services for low-income consumers.[24] The term ghetto tax is used to describe the generally higher prices those with low incomes pay for goods and services, particularly those living in poverty-stricken areas.[25]

The problem of ghetto taxes is closely associated with mobility; one study in the USA showed that higher prices might be prevalent in some neighborhoods, but people with access to a car would have more access to affordable goods and services elsewhere, whilst those without a car would bear the brunt of higher local prices.[26]

The New York State Banking Department has drawn major banks into underserved neighborhoods by placing deposits of government money, sometimes at below-market interest, in the new branches. These may enable more residents to open accounts and reduce reliance on costly check-cashers and lenders, said the state’s superintendent of banks, Diana L. Taylor.[27]

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[23] Study Documents ‘Ghetto Tax’ Being Paid by the Urban Poor By ERIK ECKHOLM Published: July 19, 2006, The New York Times.

[24] Washington Post, Ghetto tax - Sunday, July 23, 2006

[25] Talukdar, Debabrata (2008). "Cost of Being Poor: Retail Price and Consumer Price Search Differences across Inner City and Suburban Neighborhoods". Journal of Consumer Research 35 (3): 457. doi:10.1086/589563. JSTOR 589563.

[26] Georgetown Law Faculty Blog: Market Failures Mean The Poor Still Pay More". 20 July 2006. Retrieved 14 August 2011.

[27] Study Documents ‘Ghetto Tax’ Being Paid by the Urban Poor by ERIK ECKHOLM, Published: July 19, 2006; The New York Times.